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The matters contained in this publication, unless otherwise stated, are the statements and opinions of the authors of the articles, and are not promulgations by the Society.

Accounting News And Trends

Censure for Substandard Audit Work

The MICHIGAN CPA (June 1958) reports on the censure of a member for substandard work. Such action is in conformity with the Michigan Association's new program to meet this problem as described in this department (July 1958) and is similar to the action of the Oregon State Board of Accountancy also reported here (June 1958).

The Board of Directors accepted the recommendation of the Committee on Professional Ethics to censure and admonish a member in connection with the performance of substandard auditing work. Accordingly, the member was censured.

The board pointed out that each complaint of substandard audit work will be judged on its own merit, and that the primary reason for light punishment in this particular case was that it was the first instance in many years of a complaint of substandard auditing which had been referred to the Board of Directors for action, and that future offenders cannot expect the same light punishment.

Automatic Bank Reconciliation

A brief description of how one company achieves automatic payroll bank reconciliation is given by Robert D. Whisler in the INTERNAL AUDITOR (June 1958). Under this system, the payroll is issued on checks of three different colors. One color is used for the first month, a second color for the second month, and a third color for the third month. On the fourth month the first color is again used. The bank maintains a separate account for each color.

Payroll checks are printed with the instructions, "Void if not cashed within 30 days." The bank, however, is instructed to honor all checks if presented for payment within 60 days. If all checks are cashed on time, the bank account will show a zero balance prior to its reuse, and the account will be automatically reconciled.

If at the end of three months there is not a zero balance in the account, the pay checks for the month are sorted by pay date. A count of the checks in each payroll is compared with the total of checks issued to find which week's pay checks are incomplete. It is then a simple matter to sort the checks by number to determine which check or checks are outstanding.

The bank is notified to stop payment on the outstanding checks and the outstanding balance is transferred to the company's general fund. The employees who have not cashed their checks are contacted and checks are then drawn on the general fund to complete the payments.

The Audit of Municipalities and Continuing Education

The Kansas Society of CPAs has issued the first two of a series of educational bulletins for the benefit of its membership, on the subject of the audit of Kansas municipalities. Educational Bulletin No. 1, subtitled "Auditing

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ACCOUNTING NEWS AND TRENDS *is conducted by* CHARLES L. SAVAGE, C.P.A. *and member of the New York Bar. He is presently serving as a member of our Society's Committee on Legislation.*

Dr. Savage is professor of accounting and chairman of the Business Administration Division of St. Francis College.

Standards and the Audit of Kansas Municipalities," was released in the Kansas Society's NEWSLETTER of April 26, 1958. The Society is to be congratulated on its efforts to present specific aid to its members who undertake engagements of this specialized nature.

Some reports of CPAs that have been filed with the Department of Post-audits of Kansas do not fully conform to the minimum standard auditing program approved by the State Municipal Accounting Board. The series of bulletins, which have been prepared in cooperation with Department of Post-audits, will point out the more common deficiencies that have occurred.

The first bulletin emphasizes the fact that municipalities can exercise only powers conferred by law, and municipal officers handling public funds have only such power as the statutes grant and must disburse such funds in the manner provided by law. Thus, in its essence the audit must constitute an examination of the accounts and financial transactions of the municipality to determine if the funds subject to the control of the governing body have been handled in accordance with the statutory authority conferred. Of course, in addition, as was pointed out by the Supreme Court of Kansas, "Its [the county audit's] primary purpose—the purpose of the statute itself—is to determine whether the accounts and records of the county are being accurately and honestly kept. When the county commissioners, who are charged with responsibility in the matter, employ accountants to make the audit, they contract for skill, accuracy and fidelity on the part of those who represent themselves as experts in this line of work. If service which measures up to that high standard is not furnished, the breach of the contract is fundamental—it goes to the very heart of the contract."

The mark of a mature profession is one in which the members themselves,

not some outside authority, see to it that the high standards desired are maintained. This bulletin and the future ones which will deal with the most common report deficiencies, represent a serious attempt to meet the responsibilities imposed by professional status. They will be reported on in future issues of ACCOUNTING NEWS AND TRENDS.

Speeding Up Interim Closings and Reports

Many CPAs will find of interest a description of how companies are expediting the preparation of accounting reports as set forth in a bulletin of the National Association of Accountants entitled "Speeding Up Interim Closings and Reports." Practices of fifty-one companies, ranging from small to very large, are summarized in this booklet.

Most companies attributed the desire to shorten the report preparation time to such causes as management complaints, need for "proving" the forecast, growth of the company, intensified competition, decentralization of organization, and diversification of operations. Occasionally, a more instant cause was responsible, such as requirement to conform to practices of a parent company, demands of a new management, or urgent preclosing requests for information.

The approach to the problem generally taken was to make a detailed analysis of the data required for operating statements. The source of the data was determined; methods of accumulation, time required, and subsequent dependent operations were scrutinized. Companies reported that these analyses showed that basically there were two general sources of delay in closings: incomplete utilization of personnel and equipment and the lack of familiarity with the operations in each accounting link by other links of the same chain.

Company practices indicated that the means used to counteract these delays and achieve faster closings include:

1. Tightening of procedural steps of the closing through scheduling so that each employee concerned knows the "what" and "when" of the part he plays.

2. Introduction of better methods which often, though not necessarily, utilize tabulating and other accounting equipment.

3. Overcoming obstacles presented by particular classifications of information hard to complete at closing time, such as sales, job billings late in the period, accounts payable and their distribution to costs, inventories, payrolls and critical information from outlying points.

The Bank Examiner Program

"The Bank Examiner Trainee Program Offered by the New York State Banking Department" is a booklet describing the new methods of recruiting bank examiners introduced in 1957. This program seeks to combine the best elements of civil service employment with on-the-job experience within the banking industry and is a distinct departure from the practice of employing as new examiners only men with well-rounded banking experience. After a

two-year training period in both commercial and savings banks, the trainee is deemed qualified to compete for appointment as bank examiner.

In explaining the work of a banker, the booklet quotes the following definition: "A successful banker is composed of about 1/5th accountant, 2/5th lawyer, 3/5th political economist, 4/5th gentleman and scholar, total 10/5th. Any smaller person may be a pawnbroker or a promoter, but not a banker."

It then summarizes the role of bank examiner and states that it combines facets of such professions as auditor, lawyer, tax man and appraiser. Despite these statements on the broad experience necessary, an analysis of the on-the-job training program suggests, however, that experience in auditing is still the basic requisite. One-third of the specifically assigned time during the two years in commercial banks and savings institutions is spent in the auditing department.

This program was developed with the assistance of a committee of New York State bankers and is an imaginative effort to maintain and improve the quality of the service rendered by the Banking Department.

The Investment Club

A new phenomenon in the socio-business world—the investment club—is discussed by Luciano Vitale in "An Accountant Looks At Investment Clubs" (THE CONNECTICUT CPA, December 1957). At the present time there are nearly 15,000 investment clubs in the U. S., most of them established in the last few years. The investment club is a group of friends (6 would be enough; 8 to 12 is probably ideal; 20 or more create special problems) who join together to invest in securities. Usually there are no dues, but instead a fixed amount, varying in different clubs between $10 and $100, is contributed monthly by each member.

The accountant is often asked about these clubs and is frequently invited by his friends to work with them to establish one. His professional skill and ability to analyze and interpret financial information enables him to be particularly helpful in discussions of investment plans. These discussions usually follow a reading of some financial publications and "tip sheets" and decisions to buy or sell are usually arrived at unanimously.

Most clubs are not incorporated and operate as joint ventures or partnerships. Even though all members participate in decisions, one member is appointed as agent and attorney-in-fact for the club and he transmits orders to the broker. Securities should be held in "street form" by the broker who collects the dividends and remits to the member-agent who keeps a checking account for all receipts and disbursements.

Prize Articles and Public Relations

An unusual effort to assist one type of business with its accounting problems has been undertaken by the New Zealand Society of Accountants in cooperation with the New Zealand Retail Motor Trade Association (The Accountants' Journal, New Zealand, May 1958). These groups have invited entries for the best article on the subject of an accounting system for a small motor trader and garage proprietor. In addition to the professional recognition resulting from the publication of this work, the writer is to be awarded a prize of some 50 guineas.

The cited purpose of this competition is to encourage the preparation of a suitable form of accounts for the benefit of members of the Association. Joint activity of this sort with trade associations seems to be a method by which the profession can achieve better public relations.

An Adirondack View

Twenty-five years ahead is a long time—but, when over, it's very short. Our regional conference, in June, here at Whiteface Inn, was its twenty-fifth. Thirty-eight attended in 1934; 380 in 1958—a growth of 1,000 per cent!

Ahead is another twenty-five years. What will they bring to us? Here are some ideas:

1. Educational requirements up—college, or college plus, for all CPAs. And regulations up—New York included.

2. Punched-card machines for small businesses—a machine to accumulate all the general bookkeeping currently for each month.

3. Taxes continuing up—to pay for what the people want.

4. The smaller CPA offices bigger in prestige and number—like the lawyers. Less dependence on the big city.

5. A start to dropping one letter from CPA and making it just CA — MDs were never MPDs.

And, no monthly Adirondack View in this magazine — this is the last one. Perhaps some Buffalo Views, or Westchester Views. So, after ten years, we say "Adieu, kind friends, adieu;" keep your eyes on the mountains, and the valleys will take care of themselves.

LEONARD HOUGHTON, CPA
Saranac Lake Branch of
"The Adirondack Chapter"

Our readers will note, with deepest regret, this announcement of our dear friend and colleague that this issue of our magazine contains the last contribution of An Adirondack View. The last of anything good inspires sentiments of sadness and of nostalgia. Leonard Houghton submitted his first contribution to our magazine in January 1948, over ten years ago, and it has appeared as a regular monthly feature since that time. The views expressed by him reflected a unique combination of wit, wisdom, and universality of thought magnificently integrated with a concern with both the technical and over-all problems of our profession.

To Leonard Houghton, CPA, we extend, on behalf of our readers, our sincerest appreciation and best wishes.

—THE EDITOR

Letters to the Editor

The Accounting Profession in Australia

I had thought for some time of preparing a memorandum for the NEW YORK CERTIFIED PUBLIC ACCOUNTANT dealing with, first, the economic and social background to accounting in Australia, and then, in some detail, the principal features of the accounting situation here professionally and educationally. This would very likely have run to a greater length than you would care to publish in any one issue, but I felt that maybe you could split it for publication or discard part of it as you thought best for your purposes. I thought the introductory statement might have been desirable in view of the possibility that, to some of your readers, Australia may be known as the country of kangaroos, swimmers and tennis players but little else. This, of course, is a playful exaggeration, but we did find when we were in the U. S. A. in 1955 that there were few people who had an appreciation of the economic resources and problems of Australia. On more than one occasion we were even complimented on the speed with which we had "picked up" the English language—but this was not by CPAs, I must admit.

However, I hesitated about embarking on this project, because of the possibility that it might be doing your readers an injustice in imputing to them a lack of knowledge which they in fact do possess. It was this hesitation, coupled with a very full working programme in the last few months, which contributed to the rapidity with which the days and weeks slipped past me. Perhaps a few words about the professional set-up in Australia in our common field of endeavour may be of interest to your readers.

There are a number of bodies of accountants and kindred professional people in Australia, each having a national membership.

The Institute of Chartered Accountants in Australia is the nearest equivalent to the American Institute of Certified Public Accountants, in that all its members are or have been engaged in professional public accounting. Its membership at 30 June 1957 was 3,863, of whom 2,445 were in practice either on their own account or in partnership, and 531 in the employment of practising public accountants, the remainder being "on the separate list," that is, not currently engaged in public accounting. Membership of the Institute is open to persons who have been in practice themselves or in the employ of a chartered accountant for five years and who, in addition, have passed the qualifying examinations of the Institute. These examinations are in three stages—Preliminary, Intermediate and Final. Exemption from the Preliminary and Intermediate examinations is granted to certain persons, such as graduates in commerce of certain of our universities if they have passed the equivalent subjects in their undergraduate courses, or Registered Public Accountants in the states of New South Wales and Queensland. Exemption from the Preliminary and part of the Intermediate is available in other cases where professional examinations of other bodies have been passed. No exemptions, however, are available from the Final examination, which comprises three papers in Accounting, one in Auditing, one in Professional Ethics, and one in Federal Income Tax. No person may describe himself as a Chartered Accountant unless he is a member of this Institute.

The Australian Society of Accountants has a much larger membership, totalling 21,335 at 31 December 1957. Its membership is open to any person (of good repute, of course) who has passed its examinations or qualified in an equivalent manner by graduating in Commerce in recognized institutions, such as certain of our universities, technical colleges, and the like. Persons who are under 21 years of age or who have not had adequate experience in public, commercial or governmental accounting are admitted to membership as provisional associates.

The Australasian Institute of Cost Accountants is, as the name suggests, a body of cost accountants. It has recently become affiliated with the Australian Society of Accountants for administrative purposes, but retains its identity of membership, which is open to cost accountants of some experience who have qualified for admission by passing, in addition to the Society's examinations, an examination in advanced costing and factory organization. The membership of this Institute at the end of 1957 was about 2,100.

The Chartered Institute of Secretaries, with headquarters in the United Kingdom, has an active branch membership in Australia of a little more than 6,000. This is open to secretaries of corporate enterprises and other institutions, admission, again, being by examination in company law, secretarial practice (conduct of meetings, etc.), economics, etc., in addition to accounting. Membership of the Institute of Chartered Accountants or of the Australian Society of Accountants carries exemptions from the accounting examinations in this Institute.

In each of the states of the Commonwealth of Australia the formation, management and liquidation of private corporations are governed by the provisions of a Companies' Act. While there is substantial correspondence between the several state acts, there are also numerous minor differences. Most of the acts, however, provide that an auditor of a public company (that is, one which offers its shares or stock for subscription to the public) must be qualified by licence from a board set up under the Act and must pass examinations set by the board unless exempted by reason of his membership in a recognized professional accounting body, such as the Institute of Chartered Accountants or the Australian Society of Accountants, or (in Victoria) by having passed the requisite subjects in the course of the University of Melbourne leading to the Bachelor of Commerce degree. In practice, it is rare to find an auditor of a public company who is not a member of the Institute of Chartered Accountants.

It may be of interest to note that the various Companies' Acts provide that the auditor of a public company shall be elected by the shareholders in general meeting and shall report to them on the balance sheet and profit and loss account presented to them annually by the directors. Thus, in law at least, the auditor is independent of the directors, being directly responsible to the members by whom he is appointed and to whom he makes his report.

In two states—Queensland and New South Wales—statutes have been passed providing for the registration of public accountants and restricting the practice of public accounting in those states to persons qualified by examination and registration. The registration of accountants has also been under discussion for many years in Victoria and legislation has long been "imminent," but so far has not been placed on the statute book.

Auditors of municipalities must also be licensed under state Local Government Acts, which set up boards to conduct their own examinations in municipal law and accounting. The subject of municipal auditing does not form a topic

in the syllabus of examinations of any of the professional bodies.

This, in brief and broad outline and without many refining details, is the professional framework to accounting activities in Australia.

LOUIS GOLDBERG
G. L. WOOD Professor of Accounting,
University of Melbourne,
Victoria, Australia

Application of Statistical Sampling to Auditing and Accounting

Our Society's Committee on Application of Statistical Sampling to Accounting and Auditing has, as one of its primary objectives, the communication of information on this subject to the membership of the Society. In this connection, it occurs to me that the readers of this magazine would be interested in perusing an excellent report which reviews our profession's current inquiries into the subject and plans for the study and preparation of appropriate literature. This report, which is reprinted below, was submitted to the Council of the AICPA by its Committee on Statistical Sampling and covers the activities of that Committee for the fiscal year ended August 31, 1957.

ANNUAL REPORT OF THE AICPA's COMMITTEE ON STATISTICAL SAMPLING

The committee on statistical sampling, which was first appointed last October, held its organizational meeting on November 29 and 30, 1956. Since then it has met on May 2 and 3 and on September 5 and 6 of this year. It has scheduled another meeting for December 5 and 6. Up to the present time, these meetings have been devoted largely to exploring the subject of statistical sampling, to reviewing the literature on the subject, and to general discussion of the auditing and accounting problems involved. The committee is now turning to more specific projects, which I will outline briefly in the latter part of this report.

Statement of Objectives. It has been agreed by the committee members that obviously the appointment of the committee should not be interpreted as meaning that the Institute has approved, or is necessarily about to approve, statistical sampling for auditing or accounting purposes. Rather, the committee believes it should take an exploratory or research attitude toward the subject, and that it may ultimately accept the statistical approach in part, or that it may reject it wholly.

There has been considerable discussion of the statement of objectives which was submitted to committee members at the time they were appointed and it is believed that the statement should be revised to indicate more clearly the research approach that the committee must take. Accordingly, the statement of objectives has been revised, and the committee requests your approval of

the revised statement which reads as follows:

Objectives:

1. Make an impartial review of the technique of statistical sampling, exploring and evaluating its underlying assumptions and philosophy.

2. Disseminate information about statistical sampling in non-technical language.

3. Determine areas in accounting and auditing in which statistical sampling may be useful.

4. Determine specifically whether statistical sampling methods are applicable insofar as test-checking is involved in the conduct of a professional examination of financial statements.

5. If applicable, illustrate the areas in which useful and the methods that may be applied in each.

6. Prepare statements of findings for reference to the committee on auditing procedure from time to time.

The statement of methods of operation of the committee, which was included in the material sent to committee members when they were appointed, also has been revised to define more precisely the way the committee expects to proceed. As revised, it is as follows:

Methods:

1. Review literature on statistical sampling.

2. Discuss problems in meetings and by correspondence.

3. Individual members develop case studies for experimentation, to be used as basis for committee discussion and recommendation.

4. Committee solicit experimentation by others for appraisal and reporting thereon by individual committee members as basis for full committee discussion and consideration.

5. Prepare papers for discussion within committee on:

(a) Specific test-check phases of auditing.

(b) Specific audit techniques that are challenged by statisticians.

6. Provide information to the accounting profession and others, but only after clearance by committee on auditing procedure.

7. Discuss with statisticians (somewhat as a committee on relations with statisticians) the statistical soundness of the conclusions reached from time to time by the committee.

Glossary of Statistical Terms. At the request of the committee, a glossary of accounting terms which accountants are likely to encounter in studying statistical sampling was prepared by Lawrence L. Vance, a member of the committee. It is believed that this glossary would be interesting and valuable to a good many practitioners. Accordingly, the committee plans to offer it, together with a bibliography of the literature on statistical sampling, to the membership, upon individual request, as soon as some revisions in the glossary have been made and the bibliography has been prepared.

Subcommittee Projects. Three subcommittees have been appointed to deal with specific areas of statistical sampling problems. One of these, the subcommittee on estimation for accounting purposes, has been appointed to study the accounting and auditing implications involved in situations where statistical sampling techniques are being used to determine prime accounting data.

Another subcommittee, on random selection without statistical evaluation, is investigating some of the possible implications of using only a part of the statistical approach to sampling. It is also working on the question of whether randomness is in fact a requirement in sampling for audit purposes.

A subcommittee has also been appointed to study the literature on the broad subject of the purposes of audit sampling. Involved in this are such questions as: whether the sample should be representative of the universe, as is implied in a good deal of auditing literature; whether the auditor does in fact make inferences (in the mathematical sense) about the universe on the basis of sample results; and how to appraise relatively the interrelationship of sampling as a means of testing internal control and the bona fides of accounts. A further matter under consideration is clarification of the circumstances in which a sample should be self-sufficient for a particular purpose, as distinguished from those cases in which using a sample is just one step leading to a conclusion based on several steps.

Cooperation with Professional Statisticians. There has been some uncertainty within the committee as to whether the time has come when it would be advisable to establish cooperative arrangements with one or more of the recognized associations of statisticians for the purpose of exchanging viewpoints. Until now, it has been the consensus that the committee should first achieve greater familiarity with the problems involved in applying statistical techniques to auditing. However, it was decided at the last meeting that the possibility of establishing means for informally exchanging ideas with a group of professional statisticians should be explored and discussed further at the next meeting.

[End of AICPA Committee Report]

Gregory M. Boni, CPA,
Chairman of our Society's
Committee on Application
of Statistical Sampling to
Accounting and Auditing

Classified Section

RATES: "Help Wanted" 20¢ a word, minimum $5.00. "Situations Wanted" 10¢ a word, minimum $2.00. "Business Opportunities" 15¢ a word, minimum $3.00. Box number, when used, is two words. Closing date, 10th of month preceding date of issue.

ADDRESS FOR REPLIES: Box number, The New York Certified Public Accountant, 677 Fifth Avenue, New York 22, N. Y.

HELP WANTED

CPA-Attorney, tax specialist, man experienced in planning, research and review, progressive medium midtown CPA firm, presently per diem, free office facilities, good opportunity for future partnership interest. Box 1472.

SITUATIONS WANTED

Immediately Available, accountants, office managers, bookkeepers. Bookkeepers & Accountants Division, Maxwell Employment Agency, 130 West 42nd Street, N. Y. C., telephone LOngacre 4-1740.

CPA, partner in firm, 35, seeks position leading to acquisition of practice or partnership interest. Box 1458.

Financial Executive, CPA, law degree, over 25 years extensive experience, public, private, presently employed assistant comptroller manufacturing company, progress blocked, seeks more challenging opportunity, excellent references, $10,000. Box 1467.

CPA, 32, with small practice desires per diem 8-12 days monthly, excellent professional background. Box 1469.

CPA, AICPA, NYSSCPA, MBA, 16 years public accounting and tax experience, desires position in tax department of CPA firm, available two days week. Box 1473.

CPA, tax accountant, LLM taxation, experienced tax research, planning, protests and petitions, available per diem N. Y. C. area. 1480.

BUSINESS OPPORTUNITIES

Mail and Telephone Service, desk provided for interviewing, $6.50 per month, directory listing. Modern Business Service, 505 Fifth Avenue (42nd Street).

Practice Wanted, substantial terms, know-how offered overburdened or retired practitioner, CPA, N. Y., N. J., AICPA, IE, MBA. Box 1459.

Well Equipped CPA Firm, will purchase all or part of the practice of overburdened or retiring accountants, substantial cash or attractive retirement arrangements will be offered. Box 1460.

CPA, desires to purchase practice, New York City area, honor graduate, excellent tax and accounting background, specializes in highest type professional service to small and medium size accounts, excellent financial terms, replies held strictly confidential. Box 1461.

CPA, 38, Mid-Hudson area, desires association with individual or firm with partnership possibilities in view. Box 1462.

CPA, diversified experience, modest clientele, free time, seeks association with overburdened or retiring practitioner. Box 1463.

CPAs, N. Y., 2, early 30s, extensive accounting and tax experience, desire to purchase practice of an established or retiring practitioner, substantial capital available. Box 1464.

Office Space, in CPA suite, Grand Central area, secretarial service, Bruning reproducing machine, excellent environment, MU 2-7168 or Suite 1210, 41 East 42nd Street, N. Y. C.

Statistical Typing, expert for CPAs, neat quality work, midtown location, rapid service. Box 1465.

CPA, 33, 9 years public experience seeks association with individual practitioner offering partnership opportunity in other than Metropolitan N. Y. Box 1466.

1441 Broadway, sublease small air-conditioned office. LO 4-6474.

CPA, Society member, over 20 years diversified public experience, $9,000 practice, free time, seeks association with overburdened practitioner for mutual benefit. Box 1468.

CPA, 32, excellent professional background, will purchase practice to $20,000 or individual accounts on substantial terms, Metropolitan or Nassau County areas preferred. Box 1470.

CPA, 35, AICPA, NYSSCPA, Nassau office, $8,000 gross practice, substantial free time, will service, buy or share interest in Long Island accounts. Box 1471.

CPA, 33, AICPA, NYSSCPA, available 12 days a month or association with future, will buy or service accounts. HIckory 4-3048, Box 1474.

CPA, 42, small quality practice, seeks association with similar practitioner share office, junior, etc., or will rent 200 feet in dignified suite. Box 1481.

BUSINESS OPPORTUNITIES

CPA Firm, small, well-established, will operate, manage and assume tax burdens for practitioner, association or purchase, continuity and coverage provided under feasible working arrangements. Box 1475.

CPAs, 2, moderate practice, desire office with secretarial services. Box 1476.

CPA, gross about $15,000, has few days available, desires association with practitioner, aim joint administration, mutual benefits and eventual partnership. Box 1477.

Individual Practitioner, $15,000 gross, age 31, interested in association, merger, etc., or any inviting arrangement other than sale. Box 1478.

CPA, attorney, tax man, former revenue agent and technical adviser, specializing exclusively in tax and estate planning, research, litigation, audits and returns, seeks association with accounting firm in need of part time tax services on mutually satisfactory arrangement. Box 1479.

42nd Street and Fifth Avenue, share private office, completely furnished, roomy, quiet, rent $55.00 per month. Telephone YUkon 6-4453.

Stenographic Services, statistical typing, reports, rush letters and specialized work. Helen Maresca, 509 Fifth Avenue, New York 17, New York, telephone YUkon 6-4452.

Economic Analysis and Rate of Return on Investment

By L. Milton Woods, C.P.A.

The field of economic analysis for purposes of budgeting and forecasting capital expenditures is a large one, rapidly being filled by engineers and economists. The C.P.A. is in a uniquely favorable position to render a real service to management in this area because he has the financial data readily available for use in preparing these analyses, while his auditing responsibility affords ideal opportunities for preparation of progress reports on investments undertaken. There is a definite challenge to the public accountant to enter this field, if he will but accept it. This article discusses the use of the "return on investment" method of analyzing proposed capital expenditures.

Some Fundamental Principles

The use of economic yardsticks to evaluate capital investment possibilities is a subject of increasing importance in the business world of today. The supply of available investment capital is likely to decrease because of increasing tax burdens at the Federal, state and local levels. The demand for this capital will continue high, and the pressure of inflation increases this demand. Competition and rising costs are other factors which force a more careful appraisal of investments, so that a reasonable profit margin can be maintained.

Most large companies employ some concept of budgeting and forecasting capital expenditures. The preparation of the budget is often an involved task, requiring the services of accountants, engineers, and top management. In many organizations, this preliminary budget is then submitted to the board of directors for final approval. It is therefore necessary that some means be adopted in presenting the budget whereby comparisons and evaluations of the various proposals can be accurately made, so that management approval can be intelligently given to programs which will permit maximum utilization of the company's resources, and maximum profit opportunities.

L. Milton Woods, C.P.A. *and member of the Bar, is a member of the American Institute of CPAs, the American Accounting Association, and the Colorado Society of CPAs. He is engaged in the practice of accountancy in Billings, Montana.*

A Primary Axiom

Of course, there are many factors which influence the ultimate managerial decision. Nearly every substantial investment is subject to some element of risk. In some industries, this element may be very great. Therefore, if two investment opportunities do not have the same risk element, the same rate of return on the investment would not be acceptable for both cases. The evaluation of risk factors and other similar matters is the particular province of top management. This is an illustration of the primary axiom of economic evaluation: There is no formula that will fit every situation, and there is no substitute for executive judgment. The failure to recognize this axiom is the reason for much of the confusion that has arisen, both on the part of accountants and management personnel, as to the proper use of the various economic yardsticks. The whole purpose of an economic evaluation of investment opportunities is to provide a useful common denominator whereby the differences in the various opportunities may be effectively compared on a completely objective basis. Of course, the objectivity of the economic approach selected cannot be assured, unless we can be assured of the objectivity of the person making the analysis. There is no such thing as a universal method, as will be pointed out more fully, and it is in the selection and application of the proper method that the public accountant can perform his greatest service in this field. Although the company engineer may have complete command of the technical aspects of the project which he advocates, his evaluation of this project in comparison with some other project will often be less than objective. For this reason, it is important that these comparisons be made by an independent expert.

Criteria for Evaluation of Techniques

Naturally, it is axiomatic that the choice of an economic yardstick will depend upon what it is expected to do. In most cases, the following general criteria are important.

1. The yardstick should utilize the largest possible number of factors influencing the investment choice. Necessarily, this implies that each factor should influence the final result approximately to the same extent as all other factors of equal importance will influence it. Thus, if a project is expected to realize the greater proportion of its income from a single sale, it will be seen later that the timing of this sale in the calculations will have a disproportionate effect upon the final result obtained in a discounted-cash-flow type computation. In such a case, some other method may produce a better result.

2. The yardstick should produce consistent results. It is not essential when developing a method of analysis that the result be capable of translation into the same terms as the operating statement of the company. But it is absolutely essential that a result obtained under one set of circumstances will be capable of a consistent interpretation with another result obtained under another set of facts. Stated in another way, this simply means that we may use a method which rates one project as a factor *3* on a known scale, and another as a factor 5 on the same scale. It may be true that we cannot perhaps take the income statement and balance sheet for the same period and obtain a factor for the entire company, but this is not necessarily a defect in the method. It will be pointed out later that the taking of post-mortems of past estimates is rendered easier if the result of the analysis method can be directly compared with actual operating results, but this one factor is not suffi-

cient justification for abandoning otherwise usable techniques.

3. The result must be capable of being readily explained to an executive who is not a mathematician or a theoretical economist. There are many excellent devices in use today which utilize extremely advanced mathematical concepts. The results obtained are admittedly of first-class quality in those specialized situations which exactly "fit" the method. However, even in those cases in which these methods are directly applicable, their use should be restricted to those technical personnel who are thoroughly familiar with the detailed proofs involved. They have no place at the board of directors meeting.

The Development of Specific Techniques

The above criteria will seem to be very general to the reader, and this is of necessity true, for there is no single method which will fit all circumstances and no set of requirements which will satisfy the needs of every analysis. It is important to adopt a consistent approach on all similar problems, but the analyst should have no qualms in utilizing a different approach where the situation demands. Here again, the special problems of the public accountant must receive consideration. Most writers on this subject advocate a completely consistent approach to all analyses, but it must be remembered that they generally intend that the approach will be utilized only within a specific company. The practicing accountant, with his highly diversified clientele, will find it necessary to develop specific techniques to satisfy the needs of the oil producer, the manufacturing concern, the building contractor, and many others. It would be extremely unwise to adopt a single method to the exclusion of all others for application to all possible sets of facts.

This paper is intended as a presentation of some of the many types of analysis techniques, together with some general suggestions for their application.

Types of Analysis Techniques

Cash Payout

Perhaps the method of analysis and comparison most generally used is the cash payout. The payout is defined as the period of time necessary for the income from the project, after deduction of operating expenses, to exactly pay back the capital invested. Of course, this method emphasizes the liquidity of the project, and is therefore important in those instances in which liquidity is the most important single factor. For example, in those cases in which the investment and income patterns are similar, and the project lives are equal, the payout is a completely satisfactory analysis technique. Thus, let us assume that Projects A and B, each requiring \$100,000 initial investment, will have the following net cash incomes over the five-year project life:

	Project A	Project B
First year	\$ 50,000	\$ 40,000
Second year	40,000	30,000
Third year	35,000	25,000
Fourth year	30,000	20,000
Fifth year	20,000	10,000

Project A achieves a payout in the third year, and Project B achieves a payout in the fourth year. It is obvious that Project A is the more desirable investment. The payout has the decided advantage of requiring little background explanation. Most executives know what a payout is, and have learned to trust the result as a means of evaluation. The calculation of the payout is simple, requiring only simple accounting concepts of cash income and investment.

There are a number of limitations upon the payout concept. First, it does not provide any information as to the

total cash to be recovered from the project, since the payout is not concerned with the entire life of the project, except in those cases in which the life of the project is less than the payout period. This objection can be met by providing supplementary information in the analysis, such as was indicated above, showing the total performance estimated over the project life.

Second, the payout does not take into consideration the cash flows over the project life. For example, consider the following income patterns during the payout period of two projects requiring investment of $100,000:

	Project A	Project B
First year	$ 50,000	$ 20,000
Second year	30,000	20,000
Third year	10,000	20,000
Fourth year	5,000	20,000
Fifth year	5,000	20,000
Totals ..	$100,000	$100,000

Although both investments have the same payout, Case A is the more desirable on the basis of the information given, since there is a greater amount of income in the early years. An important proviso must be inserted at this point. The assumption that Case A is the more desirable implies that the resulting early cash recovery will be reinvested promptly at satisfactory profit rates. While this assumption is recognized as being desirable in the financial community, the facts of life in a particular business may not support it. If Case B presents an opportunity for a long-term investment which will satisfactorily employ capital over a long period of time, and provide a steady return, it may actually be more desirable than Case A in some circumstances. Reinvestment of capital is costly, especially when it may be necessary to reinvest large sums at a time when the opportunity for earning satisfactory profits is doubtful.

A third objection to the payout is the fact that it fails to recognize the value of a project which continues to produce substantial cash after payout. Again, let us consider two cases, each requiring the same investment:

	Project A	Project B
First year	$ 50,000	$ 20,000
Second year	40,000	20,000
Third year	10,000	20,000
Fourth year	—	20,000
Fifth year	—	20,000
Sixth year	—	19,000
Seventh year	—	18,000
Totals ..	$100,000	$137,000

If the investment required in each case is $70,000, the payout for Case A is two years, and for Case B, four years. Of course, Case B is the more desirable because it provides greater total income, and produces substantial cash beyond the payout period, whereas Case A produces only $30,000 beyond the payout period.

In general, the payout has definite limitations. Projects having different income patterns, different investment patterns, and different total lives require the application of a more refined approach. Because of this requirement, a number of techniques have been developed to permit the approximate calculation of the return on actual capital invested. All of the methods listed below involve some variation of this theory.

Average Book Rate of Return

This method computes the rate of return as the ratio of the average annual net profits from the project to the average book investment required. Thus, under this method, if the investment is to be depreciated on a straight-line basis, the following table might be prepared for a typical case:

Year	End-of-Year Depreciated Investment	Depreciation	Net Profit After Deprec.
0	$100,000	—	—
1	90,000	$10,000	$ 10,000
2	80,000	10,000	12,000
3	70,000	10,000	14,000
4	60,000	10,000	15,000
5	50,000	10,000	15,000
6	40,000	10,000	15,000
7	30,000	10,000	14,000
8	20,000	10,000	14,000
9	10,000	10,000	14,000
10	—	10,000	10,000
	$550,000		$133,000

Rate of return = 133,000/550,000 = 24.2%

This method has some quite obvious shortcomings. In the first place, since the investment is retired on the basis of book depreciation, no consideration is given to particular cash income flows. In the above example, any income pattern (i.e., rising, falling or completely stable) which gives a total net income after depreciation of $133,000 will produce the same result in the formula. The method is more widely used in those situations in which depreciation can be approximately related to income, as in the extractive industries, where unit of production depreciation is used. However, even when unit of production depreciation is used, the method is still open to the objection of failing to recognize the actual flow of cash in recovering the investment. It does have the advantage of providing a result which is easily comparable with historical financial information.

Engineer's Method

This method, commonly used by engineers in performing economic analyses of projects, involves the use of the present value of future earnings and investment. This method overcomes some of the shortcomings of the payout and average book rate of return. Under this method, it is assumed that cash recovered from a project can be reinvested immediately at a favorable interest rate. As was pointed out above, this assumption may or may not be valid in a particular situation.

An optimum rate of return is selected, such as 10 per cent. Then, cash income for each year is discounted at this chosen interest rate. The sum of these present values is then compared with the present values of investment required. If this comparison indicates that the project will earn more than the optimum rate, it is considered desirable. Conversely, if it earns less than the optimum rate, it is not considered sufficiently remunerative. An example will serve to illustrate the technique. Let us assume investment and cash recoveries as set forth in the following table. Present values of the cash recoveries are computed in the fourth column.

Year	Investment	Cash Recovery	Present Value @ 10%
1	$100,000	$ 20,000	$ 18,180
2	—	30,000	24,780
3	—	40,000	30,040
4	—	40,000	27,320
5	—	30,000	18,630
	$100,000	$160,000	$118,950

It will be seen from the above example that this investment will earn more than 10 per cent, and if 10 per cent is considered the optimum investment rate, the project will be considered desirable.

The major objection to this method is the fact that it only categorizes the investment as being above or below an arbitrarily selected rate. Therefore, the entire analysis depends upon the selection of the proper rate. Some have suggested that this rate should bear some direct relationship to the cost of obtaining investment capital. Although this is one answer, the profit requirements of a company will not always bear a direct relationship to the cost of investment capital. Other requirements, such as utilization of existing facilities

and personnel make it extremely desirable to know the exact rate of return from a proposed investment.

Another difficulty with the engineer's method will be observed when it is necessary to make comparisons between projects. Because the method does not assign a particular rate to the project under consideration, the relative profitability of two projects is difficult to assess. These problems bring us naturally to a refinement of the engineer's method, sometimes referred to as the discounted cash flow method.

Discounted Cash Flow Method

The example used to illustrate the engineer's method indicated a return in excess of 10 per cent. The following tabulation includes calculations of present values at 15 per cent, 16 per cent and 17 per cent for the same example.

Year	Investment	Cash Recovery	Present Value @ 10%	Present Value @ 15%	Present Value @ 16%	Present Value @ 17%
1	$100,000	$ 20,000	$ 18,180	$ 17,400	$ 17,240	$ 17,100
2	—	30,000	24,780	22,680	22,290	21,930
3	—	40,000	30,040	26,320	25,640	24,960
4	—	40,000	27,320	22,880	22,080	21,360
5	—	30,000	18,630	14,910	14,280	13,680
	$100,000	$160,000	$118,950	$104,190	$101,530	$ 99,030

The above tabulation indicates the actual rate to be between 16 and 17 per cent. Simple interpolation yields approximately 16.6 per cent as the actual rate of return on unrecovered investment. That this is the correct rate is shown in the following proof calculation:

Year (1)	Cash Recovery, End of Yr. (2)	Unrecovered Investment, Beg. of Yr. (3)	Return On Investment @16.6% (4)	To Retire Investment (3)-(4) (5)	Unrecovered Investment, End of Yr. (6)
1	$ 20,000	$100,000	$ 16,600	$ 3,400	$ 96,600
2	30,000	96,600	16,036	13,964	82,636
3	40,000	82,636	13,718	26,282	56,354
4	40,000	56,354	9,355	30,645	25,709
5	30,000	25,709	4,268	25,732	(23)
To balance		(23)	23	(23)	—
	$160,000		$ 60,000	$100,000	

This method gives full recognition to all cash flows, both of investment and income. A definite rate of return is assigned to each set of facts, so that comparisons of projects can be made on a consistent basis. Thus, the primary objections to the engineer's method are completely satisfied. If there is a substantial objection to the discounted cash flow method in particular applications, it will probably arise from the fact that the underlying assumption of immediate reinvestment does not conform to the facts of the situation encountered.

Mechanics of Analysis

At this point, it is well to review some of the mechanics of the analysis. Although these comments are directed primarily to the use of the discounted cash flow method, because it involves the most sophisticated approach, some of them are applicable to other methods as well.

Investment

The investment should include all investment in the project, regardless of whether it is charged to expense or capitalized on the company books. The question sometimes arises as to the proper treatment of existing investment which is utilized in a project. If the existing investment can be effectively utilized other than on the project, and the project will prevent this other use, then the project should be burdened by the economic value of such other use. Such economic value may be zero if it is unnecessary to replace the use of the existing investment which would be eliminated by the project. This is another way of saying that only incremental investment should be considered when analyzing the profitability of a proposed new project.

Operating Expenses

Operating expenses should include only those additional cash expenses attributable to the project. Direct expenses will generally be capable of fairly accurate estimation, but overhead items and administrative expenses are more difficult to estimate. Generally, it can be stated that a small project which will be developed within existing supervisory and administrative framework will probably generate little if any additional cost in this area. Therefore, it is plainly incorrect to burden a proposed project with a flat percentage representing the present overhead and administrative expense rates, since existing supervision must be absorbed whether there is a new project or not. However, it is dangerous to over-generalize this concept. If one small project will not cause additional supervision which can be directly attributed to it, can we extend this to the second project? If so, how far can we extend this reasoning? If the tenth project will require some substantial additional administrative cost, is it fair to burden that one project with the entire increase, or ought we to assume that there will be further development which will help to absorb these costs? All of these questions can be answered in a number of ways. The engineer recommending a project is likely to adopt the "free ride" concept and assume that additional supervision will either be nominal or incapable of accurate determination. At the other end of the scale is the cost accountant who insists on full absorption of overheads through distribution over existing and projected programs.

It is submitted that the correct approach is somewhere between the two extremes. A new project must absorb costs generated by it, including additional administration. In a particular situation, the analyst will be able to assess the situation more accurately, but, in general, the project should be burdened by administrative costs at some rate which will permit absorption of additional administration required over the development period. This may result in a very nominal administrative cost for small projects and, in such cases, it can of course be ignored. It goes without saying that large projects requiring separate supervisory staffs must bear the full cost of this supervision. In order to simplify the computations, minor additional investment may be added to operating expenses in the year in which it is incurred.

Income Taxes

Because many projects will have an effect upon total income tax liability which is proportionately greater or less than the cash income derived from the project, it is often desirable to calculate the approximate income tax attributable to the project in each year, and reduce cash income by this amount in making the rate of return calculation. This is particularly important in those instances in which specialized tax deductions, such as percentage depletion, are available for the project, or where foreign tax credits are involved. In any case, the analysis must clearly indicate whether federal income taxes have been considered in making the calculations.

Achieving Accuracy

The calculation of the exact rate of return is primarily a trial-and-error problem, although charts and special formulae can be developed for special-type situations. The public accountant dealing with a variety of situations will generally find these special approaches of such limited application as to be of little value. Some experience with the trial-and-error approach will greatly shorten the computation time. The beginner may fall into an error which will seriously increase the number of trials required to obtain the answer. In the example used (page 554), the error in interpolating the rate resulted in only a $23 distortion in the final proof. In the higher percentages, and when income and investment patterns are erratic, the rates become very sensitive, producing a large balance in the proof calculation. It may be necessary to carry the rate to four or five decimal places in order to reduce this balance to a reasonable figure. This is not at all necessary, since the basic estimates will ordinarily not be accurate enough to permit a significant refinement of the rate beyond the decimal point. In the above example, a rate of approximately 17 per cent is indicated. It should be noted that the example was prepared from three-place present-value tables. In general, it must be recognized that all forecasts are subject to some degree of error, and there is no point trying to develop a rate more significant than the source data.

In this connection, it is well to mention the matter of specific timing of income and investment. In the example, it was assumed for purposes of calculation that the investment was made at the beginning of the project, and all income was received at the end of each succeeding one-year period. Of course, these particular assumptions are arbitrary, but it is necessary to choose some logical point in time for spacing of income and investment so that the calculation can be made in one operation. The analyst will do well to experiment with different timing patterns to determine the extent of possible distortion. One word of caution: When dealing with present-value tables there is a temptation to obtain mid-year discount factors by simple interpolation. This is not possible, and the distortion may be considerable in the higher percentages. If mid-year factors are justified by the accuracy of the estimates, they should be obtained mathematically from the present-value formula.

Post-Mortems

No economic forecasting program can become effective until there is also a program of review of actual investments and comparison of operational results with original estimates. The information gained from such comparisons will serve as the basis for refinements in future analyses. Instances of substantial error must be brought to the attention of management. For this reason, progress re-

ports will assume as much importance as the original analysis report. The preparation of progress reports is made a great deal simpler if the analysis method permits comparison of actual operating results with the original estimates. Some companies prepare payout reports for various segments of their operations. Payout information can be obtained directly from operating statements in most cases. Likewise, the average book rate of return can be calculated for a project from the operating statements. When using the present-value methods, however, it is impossible to calculate the actual rate of return before the end of the project. In such cases, the progress report should merely compare the estimated income and investment with actual experience.

Need for New Management Controls and Services

The far-reaching social, scientific and technological advances have affected materially the size and complexity of our business and industrial organizations and have greatly intensified management's concern with organization, management controls and efficient administrative procedures. They have also led to fundamental changes in management concepts and techniques. We have, for example, seen great emphasis placed on employee relations. We have observed the application to clerical office work of methods, formerly identified only with factory operations—time standards, incentives, work measurement, quality control. We have witnessed the growing need for more and timelier information, the mounting burden of paperwork, the tremendous growth in the number of clerical workers, and, more recently, the trend towards scientific approaches to important management decisions requiring better and more complete data not even yet fully available. These and other factors have led to and accelerated the development of new data processing mechanisms of unprecedented speed and power which in turn have materially altered existing concepts of organization and of the utilization of mechanically produced data in decision-making and management control. . . .

What an opportunity for the accountant and auditor to assist top management in solving many of the problems which these questions pose and in fashioning the accounting function into one of management's strongest instruments of planning and control! Accounting based on purely historical concepts will make little, if any, contribution to the questions raised and concerns expressed by these executives. To be sure, historical accounting and auditing have their vital and indispensible role to play in the discharge of management's responsibilities to investors, credit grantors, the government and in many other important outside relations. However, to be useful to management with its internal problems, accounting must have the forward look. The accounting system must provide means to plan and coordinate future operations, measurements to evaluate performance in relation to these plans, means to enable management to fix responsibility for performance and to indicate the areas where action to improve it should be taken. To accomplish these important management objectives, far-reaching changes, often affecting the entire organizational structure and the methods and procedures in the financial, operating and service departments, are required.

JOSEPH PELEJ, "The Auditor's Role in Management Services,"
THE PRICE WATERHOUSE REVIEW, June 1958

Estates and Trusts—Certain New Income Tax Concepts

By Willard R. Powell, C.P.A.

The Internal Revenue Code of 1954 adopted certain new concepts of income taxation of estates, trusts, and their beneficiaries. These new concepts have resulted, for the most part, in benefits which were not available in the past. In this article, the author discusses the distributable net income limitation, the separate share rule, the tier system, and the carryover of net operating losses, capital losses, and excess deductions of an estate or trust to their beneficiaries.

Fiduciary Accounting Concept of Income

The fiduciary accounting concept of income is still important in determining the taxation of income of estates, trusts, and beneficiaries of estates and trusts under the 1954 Code. Section 643(b) defines the term "income" to mean income determined under the terms of the governing instrument and applicable local law (i.e., fiduciary accounting income) when such term is not preceded by the word "taxable," "distributable net," "undistributed net," or "gross." This definition is a new addition to the Code and was inserted to eliminate the difficulty occasioned under Section 162 of the 1939 Code where the term "income" was used in certain contexts to mean "gross income" and in others to mean income for fiduciary accounting purposes.[1] It is particularly important in connection with the determination of the deduction for distributions to beneficiaries under Sections 651(a) and 661(a)(1). These sections provide that a deduction shall be allowed in computing taxable income for the amount of the income which is required to be distributed currently. Since the latter term "income" is not preceded by descriptive adjectives, such as "taxable" or "gross," income referred to in these provisions is fiduciary accounting income.

Distributable Net Income

Having determined the deduction for income required to be distributed currently by reference to fiduciary accounting income, and adding thereto any other amounts properly paid, credited, or required to be distributed for such taxable year, the deduction so determined is limited to an amount which does not exceed "distributable net income." This term is also new with the

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1954 Code and is defined in Section 643(a). In general, distributable net income means taxable income with adjustments for distributions to beneficiaries, the personal exemption, capital gains and losses, extraordinary dividends and taxable stock dividends, tax-exempt interest, foreign income, and the dividend exclusion.

The distributable net income limitation was inserted in the 1954 Code to give the income beneficiary the benefit of certain statutory deductions, such as trustees' commissions allocable to corpus, which may have been otherwise wasted, and to eliminate certain inequities which resulted under the 1939 Code.[2] For example, consider the tax results of a trust which has taxable dividend income of $100,000 and trustees' commissions of $8,000, of which $5,000 is chargeable against income and $3,000 is chargeable against corpus. The fiduciary accounting income would amount to $95,000 and, assuming the trust instrument provides that all of the income is to be distributed currently, the beneficiary would receive $95,000. Under both the 1939 and 1954 Codes, the trust would have net taxable income, before deductions for distributions to the beneficiary and the personal exemption, of $92,000. Under the 1939 Code, the trust was entitled to a $95,000 distribution deduction, the amount of income required to be distributed currently. Conversely, $95,000 was taxable to the beneficiary. Thus, neither the trust nor the beneficiary received the benefit of the deduction of $3,000 for trustee's commissions chargeable to corpus. Under the 1954 Code, the distribution deduction allowable to the trust and, conversely, the amount of income taxable to the beneficiary, is limited to the distributable net income, or $92,000. Thus, the trustee's commission of $3,000 charged to corpus reduces the income taxable to the beneficiary under the 1954 Code.

Distribution of Stock Dividend to Income Beneficiary

The distributable net income limitation was also designed to correct certain inequities resulting from other transactions, such as the distribution of a stock dividend to an income beneficiary. It had been held, under the 1939 Code, that such a distribution was taxable to the beneficiary even though the stock dividend was not taxable in the hands of the trust.[3] Irrespective of the purpose of this limitation, unless all of the distributable net income of an estate or trust (or of a beneficiary's "separate share" of a trust) has been distributed, a beneficiary will be taxable upon the receipt of a distribution of stock which had been received as a non-taxable stock dividend by the estate or trust. This is illustrated in the following example.

A trust has received ordinary cash dividends of $100,000 and a non-taxable stock dividend valued at $20,000 which, for fiduciary accounting purposes, the trustee allocates to income. Under the trust instrument, the trustee is required to distribute 50 per cent of the income to Beneficiary A, and accumulate the remainder. Because of the terms of the trust instrument, the "separate share" rule does not apply. Accordingly, Beneficiary A is paid $50,000 in cash and one-half of the stock dividend, or a total of $60,000 in cash and property. Since the income required to be distributed currently is $60,000 (50 per cent of the fiduciary accounting income), and since this amount does not exceed distributable net income ($100,000), the trust will be entitled to a distribution deduction of $60,000 and, conversely, Beneficiary A will be taxable on $60,000. Thus, Beneficiary A will be taxable on a distribution of part of the stock dividend, which was not taxable upon receipt by

the trust, due to the fact that all of the distributable net income was not distributed. If all of the income had been distributed, Beneficiary A would have received distributions totalling $120,000 in value, but would have been taxable on only $100,000.

Although the distributable net income limitation has corrected certain inequities, it has also created others. It is not within the scope of this discussion to set forth these inequities[4] nor the legislation which has been proposed to eliminate them.[5]

The Separate Share Rule

It was assumed in the above example that the "separate share" rule did not apply. If it had applied, Beneficiary A would have been taxable on an amount not in excess of the distributable net income of his share. This rule provides that *for the sole purpose of determining the amount of distributable net income,* in the case of a single trust having more than one beneficiary, substantially separate and independent shares of different beneficiaries in the trust shall be treated as separate trusts.[6] (Note that this rule does not apply to estates, nor is it elective.) Thus, if the separate share rule had applied to the trust in the above example, and if Beneficiary A's share was limited to a 50 per cent interest in the trust, the distributable net income of his share ($50,000) would be the maximum amount taxable to him. Consequently, the separate share rule serves, in this case, to maintain the non-taxable character of the stock dividend which had been distributed to Beneficiary A. It is interesting to note that since the stock dividend was income required to be distributed currently under Section 661(a)(1), the distribution of this stock would not result in an "accumulation distribution" under the "throwback provisions."[7]

Congress granted the Secretary or his delegate broad authority to prescribe regulations as to when and in what manner the separate share rule shall apply. The regulations[8] contain considerable detail in this respect. In general, the applicability of this rule depends upon whether the trust instrument provides for distribution of income, accumulated income, and corpus to beneficiaries in the same manner as if separate trusts had been created. Thus, if a distribution to one beneficiary does not affect the proportionate share of income, accumulated income, or corpus of any shares of the other beneficiaries, the separate share rule will generally apply. Furthermore, the rule may apply even though more than one beneficiary has an interest in a given share, or even though a given beneficiary has an interest in two or more shares.

If, however, the beneficiaries of a trust have separate shares in respect to the distribution of income, but the trust is subject to an unlimited power of one beneficiary to invade the corpus of the entire trust, the separate share rule would not apply. Where the power to invade corpus of the entire trust is limited, and where the possibility of such invasion is remote, the separate share treatment may still apply.

The Tier System

Another new concept in the 1954 Code closely related to the distributable net income limitation is the so-called "tier system." Code Section 662(a) sets up two "tiers" of distributions to beneficiaries: (1) amounts required to be distributed currently, and (2) any other amounts properly paid, credited or required to be distributed. Section 662(a)(2) provides further that if the sum of the distributions under both tiers exceeds distributable net income,

then the beneficiaries in the second tier shall include in their gross income only the amount by which distributable net income exceeds distributions under the first tier. (Taxable income of the first tier beneficiaries is, of course, also limited to distributable net income.) Thus, one of the results of the tier system is to pass to the second tier beneficiaries the benefit of corpus charges which have been deducted against taxable income, to the entire exclusion, in many cases, of the first tier beneficiaries.

Let us examine the application of this provision to a trust which provides that 50 per cent of the income is required to be distributed to Beneficiary A and the other 50 per cent of the income may, in the sole discretion of the trustee, be distributed to Beneficiary B. Let us further assume that the fiduciary accounting income of the trust is $100,000, all of which is taxable, and that corpus charges of $25,000 have been paid during the taxable year, resulting in distributable net income of $75,000. The trustee pays Beneficiary A $50,000, as required by the trust instrument, and decides that it would be prudent to pay the other 50 per cent of the income, or $50,000, to Beneficiary B pursuant to the discretionary power granted him under the trust instrument. Each beneficiary received $50,000; however, under Section 662(a), Beneficiary A will be required to include $50,000 in his taxable income, whereas Beneficiary B, the second tier beneficiary, will be required to report only $25,000.

In the above example, it can easily be seen that Beneficiary B reaps the benefit of the corpus charges deducted against taxable income to the entire exclusion of Beneficiary A. It may be that Beneficiary B has received a benefit which was not contemplated by the settlor of the trust. Then, again, the benefit may not actually exist since it is possible that the "tax-free" portion of the distribution will be taxable to Beneficiary B as an "accumulation distribution" under the "throwback provisions."

Carryover of Unused Losses and Excess Deductions

A much-needed addition to the Code appears in Section 642(h) which provides for the carryover to beneficiaries of unused losses and excess deductions upon termination of an estate or trust. Under the 1939 Code, these loss carryovers and excess deductions were completely lost and resulted in no tax benefits to any of the related taxpayers.[9] By the inclusion of this section in the Code, Congress has extended the application of the "conduit theory" to these deductions.

Upon the termination of an estate or trust, this section allows a carryover to the beneficiary of any unused net operating or capital losses, and a carryover of the excess of the deductions (excluding the deduction for personal exemption and for charitable contributions) over gross income for the last taxable year of the estate or trust. This latter carryover will be referred to hereinafter as an "excess deduction."

As noted above, all deductions allowed under the Code, except the deduction for the personal exemption and the deduction for charitable contributions, are allowable in computing an excess deduction. The question may arise as to whether or not the deduction for distributions to beneficiaries is also allowable for this purpose. This can be answered very simply by reference to Sections 651(b) and 661(a) which limit the deduction for distributions to beneficiaries to an amount which does not exceed distributable net income. Although in most cases a distribution will have been made in the year of termina-

tion, it is impossible for an estate or trust to have an excess deduction and, at the same time, have distributable net income. Consequently, even though the Code does not specifically exclude the deduction for distributions to beneficiaries in computing an excess deduction, as a practical matter no deduction would be available.

It should be noted that Congress has granted the Secretary or his delegate broad authority to prescribe regulations as to the allowance of the deductions to beneficiaries under Section 642(h). Both the section of the Code and the Committee reports on this section are lacking in detail. Consequently, reference to the regulations[10] is necessary to determine the specific application of this section. The regulations provide that a net operating loss carryover and a capital loss carryover are allowable as deductions to a beneficiary in computing both taxable income and adjusted gross income. In addition, such losses retain the same character in the hands of the beneficiary as in the hands of the estate or trust. Thus, a beneficiary entitled to a capital loss carryover of $10,000 from an estate or trust could use such carryover to offset capital gains and, to the extent not so used, apply $1,000 against his ordinary income. He would be entitled to use the capital loss carryover (or net operating loss carryover, as the case may be) and still elect to use the standard deduction since these loss carryovers are deductions allowable in computing adjusted gross income. The situation is different in the case of an excess deduction. In order to obtain the benefit of an excess deduction, the beneficiary must itemize his deductions since an excess deduction is not allowable in computing adjusted gross income.

Under the Code, net operating losses and capital losses may be carried over for a five-year period. (Although not pertinent to the problem at hand, net operating losses may, of course, also be carried back two years.) In the case of loss carryovers from an estate or trust to beneficiaries under Section 642(h), the regulations provide that the beneficiaries may carry over and deduct these losses (subject to the limitations under the Code) for the remaining portion of such five-year period. The first taxable year of the beneficiary to which such losses shall be carried over is the taxable year of the beneficiary in which or with which the estate or trust terminates. However, the last taxable year of the estate or trust (whether or not a short taxable year) and the first taxable year of the beneficiary to which a loss is carried over, each constitutes a taxable year for purposes of determining the number of years to which a loss may be carried. Thus, if an estate or trust terminates on December 31, 1957 having a $10,000 net operating loss carryover from 1955, the beneficiaries, assuming they report on a calendar year basis, would be entitled to deduct such loss in 1957 and, to the extent not used, carry the remaining portion over to 1958 and 1959. The calendar year 1957 of the estate or trust and the calendar year 1957 of the beneficiaries would each constitute a taxable year in determining the period to which such loss could be carried.

Neither a net operating loss, a capital loss, nor any portion of any item of income or deduction which is taken into account in determining a net operating loss or capital loss carryover from the estate or trust for its last taxable year, can be taken into account again in determining an excess deduction. However, if the last taxable year of the estate or trust is the last year in which a deduction on account of a net operating loss may be taken, the deduction,

to the extent not absorbed in the taxable year by the estate or trust, is considered an excess deduction. This is not true in the case of a capital loss. If the year of termination is the last year to which a capital loss carryover can be carried, the estate or trust would normally be allowed a deduction for the capital loss against ordinary income, limited to a maximum of $1,000. Since this deduction is further limited to an amount which does not exceed taxable income[11] (determined before deducting any part of the capital loss) and, since an estate or trust would not have taxable income in the same year in which it has an excess deduction, no deduction would be allowable for the capital loss carryover.

It can be seen that an estate or trust having a net operating loss or capital loss carryover which will expire unused, based on the estimated or anticipated future income of the estate or trust, will want to plan to terminate as early as possible. In this way, the beneficiaries will have a longer period of time in which to avail themselves of these deductions.

In contrast to loss carryovers, an excess deduction is allowable only in the taxable year of the beneficiary in which or with which the estate or trust terminates, whether the year of termination of the estate or trust is of normal duration or is a short taxable year. No carryover of any unused portion of the excess deduction to future taxable periods is allowed to a beneficiary. In the event that an excess deduction is anticipated in the year of termination of an estate or trust, it would seem prudent to plan the year of termination, to the extent possible, to coincide with a year in which the beneficiaries will have sufficient income to avail themselves of the maximum amount of the excess deduction.

Beneficiaries Entitled to Carryovers

The question naturally arises as to which beneficiaries are entitled to the carryovers. This question becomes important in cases where the income and principal beneficiaries are different individuals. Then again, there may be two classes of principal beneficiaries—those entitled to a specific bequest, and those entitled to a residuary bequest. In general, the regulations provide that these carryovers are allowable to those beneficiaries who bear the burden of the loss. Thus, these carryovers are usually allowable to the residuary principal beneficiaries, rather than to the beneficiaries of specific bequests. The same rule applies to both estates and trusts in this respect.

However, an exception to the general rule applies in the event the estate or trust does not have sufficient assets, upon termination, to satisfy a specific bequest. In such a case, these carryovers will be allowed to the beneficiary of a specific bequest to the extent that the full specific bequest is not satisfied. For example, consider the case of an estate which has, upon termination, only $90,000 of assets available for distribution to the beneficiaries. The decedent's will provides for a specific bequest to Beneficiary A of $100,000, and a bequest of the residue of the estate to Beneficiary B. In the year of termination, the estate has an excess deduction of $30,000. In such a case, Beneficiary A would be entitled to a carryover of the excess deduction in the amount of $10,000 since only $90,000 of his $100,000 specific bequest was satisfied. The remaining $20,000 of excess deductions would be allowable to Beneficiary B. This example also illustrates the point that a beneficiary may be entitled to carryovers upon termination of an estate or trust even though such beneficiary did not receive any distribution.

As stated above, the character of these carryovers remains the same in the hands of the beneficiaries as in the hands of the estate or trust. If there are two or more types of carryovers involved, each class of carryover will be apportioned between the beneficiaries. If, in the above example, the estate had a net operating loss carryover of $10,000 and a capital loss carryover of $20,000, instead of the $30,000 excess deduction, Beneficiary A would be entitled to one-third of the net operating loss carryover, and one-third of the capital loss carryover. Similarly, Beneficiary B would be entitled to two-thirds of each class of carryover.

The Year of Termination

The year of termination of an estate or trust has become more important since enactment of the 1954 Code in view of the new provision allowing carryovers of losses and excess deductions to beneficiaries. In the case of loss carryovers, the year of termination determines the first year to which the beneficiary will be entitled to deduct such losses. In the case of an excess deduction, the year of termination determines the only year in which the beneficiary may deduct such carryover. The year of termination is not always easy to determine. For example, an estate may distribute substantially all of its assets in December of one year, the executors may render their final accounting to the court in June of the following year, and the final decree of the court may not be issued until January of the succeeding year. In such a case, the question naturally arises as to what year or in which year did the estate terminate.

For fiduciary accounting purposes, the period of administration of an estate terminates when a court issues the final decree. The issuance of the court's decree will not necessarily govern the date of termination of an estate for federal income tax purposes. The regulations[12] state that the period of administration cannot be unreasonably prolonged and that the estate will be considered terminated for federal income tax purposes after the expiration of a reasonable period for the performance by the executor of all the duties of administration. Further, an estate will be considered as terminated when all the assets have been distributed, except for a reasonable amount which is set aside in good faith for the payment of unascertained or contingent liabilities and expenses (not including a claim by a beneficiary in the capacity of a beneficiary). To emphasize, if all of the assets of an estate are distributed except for an amount to cover the payment of a claim by a creditor, the estate may be deemed to have been terminated for federal income tax purposes, even though such creditor may also be a beneficiary.

As to when a trust terminates, the rules applicable to an estate generally apply. However, the regulations specifically state that the technicality of rendering a final accounting does not necessarily govern the date of termination of a trust. (The regulations do not specifically state that the rendering of a final decree of a court does not necessarily govern the date of termination of an estate; however, it would seem that this is implied.) Furthermore, a trust does not automatically terminate upon the happening of the event by which the duration of the trust is measured. A reasonable time is permitted after such event for the trustee to perform the duties necessary to complete the administration of the trust. For example, if a trust instrument provides that income is to be accumulated until the beneficiary attains age 21, after which all of the assets of the trust are to be distributed to the beneficiary, the trust will not neces-

sarily terminate for federal income tax purposes on the day the beneficiary becomes 21. It may be necessary for the trustee to perform certain administrative duties subsequent to the beneficiary attaining age 21 and prior to the distribution of the assets of the trust to such beneficiary. During this period of administration, all of the income of the trust will generally be considered to be currently distributable. Consequently, even though no distributions of income during this period of administration are made to the beneficiary, the beneficiary will be taxed on such income.

Income and Deductions Subsequent to Termination

Income, losses, and deductions subsequent to the time a trust is deemed to have been terminated are treated in an entirely different manner. Subsequent to termination, they will be considered as the income, losses and deductions of the person entitled to succeed to the property.[13] In the case of an estate, income during the period of administration is not taxable to the beneficiaries unless, under the terms of the will, income is required to be distributed, or actual distributions have been made.[14] Once an estate is deemed to have terminated, the treatment of income, losses, and deductions is the same as that of a trust which has terminated.[15]

This difference in treatment is particularly important in the event the estate or trust has an excess of deductions over income, or net capital losses. If the estate or trust is considered to be in administration, such excess deductions or capital losses are not available to the beneficiaries for the current year, and will not be available until such time as the estate or trust is deemed to have terminated. Even then, excess deductions of a year during which an estate or trust is in administration will be lost forever. However, if the estate or trust is deemed to have been terminated prior to the time of sustaining such excess deductions or capital losses, these deductions and losses will be available to the person succeeding to the property of the estate or trust, even though the assets of the estate or trust may still be held by the executor or trustee.

For example, consider the case of a calendar year trust which, under terms of the agreement, provides for the accumulation of income until the beneficiary attains age 21, at which time all of the assets of the trust are to be distributed to such beneficiary. On February 28, 1957 the beneficiary (who reports on the calendar year basis) becomes 21, but the trustee does not distribute any assets to him until November 30, 1958. It is ultimately determined that twelve months would be a reasonable period of administration and that the trust terminated on February 28, 1958. During the period March 1 to December 31, 1957, the trust had net ordinary income of $20,000, and net capital losses of $5,000. The ordinary income would be deemed to be currently distributable and, as such, taxable to the beneficiary. The capital loss would not be available to the beneficiary in 1957. During the period subsequent to February 28, 1958, the date of termination, the trust has dividend income of $15,000, deductions of $500, and a capital loss of $2,000. (For the sake of simplicity, it is assumed that the trust had no income, deductions, or losses during the period January 1 to February 28, 1958.) The dividend income would be taxable to the beneficiary the same as if he had actually received such dividends. The capital loss would also be deemed to be that of the beneficiary, as would the deductions of $500. However, the beneficiary could not claim these de-

ductions unless he itemized deductions on his return. In addition, he would be entitled to the capital loss carryover of $5,000 which had been sustained by the trust in 1957. It should be noted that the beneficiary would be claiming this capital loss carryover in the second year of carryover since the trust's short taxable period ended February 28, 1958 (the date of termination) would be considered the first year of carryover.

Non-Applicability to New York State Income Tax

In conclusion it should be noted that these new concepts apply only in the case of the federal income tax. New York State has not adopted the distributable net income limitation, the separate share rule, the tier system, or the carryover to beneficiaries of net operating losses, capital losses and excess deductions. Furthermore, the author is not aware of any pending legislation in New York for the adoption of these concepts.

References

1. Senate Committee Report No. 1622, 83d Congress, 2d Session, p. 345.

2. In *Johnston* v. *Helvering*, 141 F. 2d 208 (2nd Circuit 1944; cert. den.), affirming 1 TC 228, it was held that a beneficiary was taxable on his distributable share of proceeds received by a trust from a defaulted mortgage even though the total proceeds were less than the principal of the mortgage. Similarly, *Warburton*, 30 TC —, No. 4 (1958).

3. *McCullough* v. *Commissioner*, 153 F. 2d 345 (2nd Circuit 1946).

4. For an excellent discussion of the resulting inequities, see Thrope, "Corpus Expenses—A Fiduciary's Dilemma," THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT, August 1956, p. 484; also Thrope, "Fiduciary Conflicts Arising Out of Corpus Deductions," THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT, October 1957, p. 682.

5. First Report of the Advisory Group on Subchapter J of the Internal Revenue Code of 1954, dated May 8, 1957.

6. Section 663(c).

7. Sections 665-8. In order to have an accumulation distribution, Section 665(b) requires that there be a "distribution" under paragrpah (2) of Section 661(a), rather than paragraph (1).

8. Regulation Section 1.663(c).

9. *Neave*, 17 TC 1237.

10. Regulation Section 1.642(h).

11. Section 1211(b).

12. Regulation Section 1.641(b)-3.

13. Regulation Section 1.641(b)-3(c) and (d).

14. *Commissioner* v. *Stearns*, 65 F. 2d 371 (2nd Circuit 1933; cert. den.); *Horace Greeley Hill, Jr., et al.*, 24 TC 1133.

15. In *Charlotte Leviton Herbert et al.*, 25 TC 807, the Court stated that the net income reported by the estate in 1949 (a period subsequent to the date the estate was deemed terminated), is taxable to petitioner "as her own,"

Fund-Raising Costs

By Louis H. Cole, C.P.A.

The public's attitude toward philanthropic organizations centers not only on the adequacy of the services available but also on how much of the contributors' dollars is actually spent on the program proper. On the other hand, the organization's objective is to secure and retain public support at a cost which it believes reasonable and necessary to accomplish this purpose. This article endeavors to reconcile these factors through presentation of principles for allocation of costs to fund raising and public education, both of which constitutes cost of public support.

Fundamental Concepts

Current Concept of Public Support

The objectives of philanthropic organizations are successfully achieved only to the extent to which public support is attracted and retained. The public's acceptance and approval of the program offered make it possible for organizations to give service at least at the current level of operations. They also provide the impetus needed to improve and expand these services.

With the tremendous growth in the number of philanthropic organizations over the years, each endeavoring to obtain the maximum public support for its particular program, the methods of securing and holding the interest of the public have undergone significant change. In contrast to the once-a-year fund-raising appeal which represented the principal contact with the public, today organizations must conduct a year-round program of cultivation and education.

The Cultivation and Education Program

The cumulative gains resulting from this continuous program are reflected in the degree to which the services are utilized and the extent of the financial support received. The year-round activity therefore has three main objectives.

First is the cultivation of the public and community-minded groups whose financial support stems from a strong interest in the service program of the organization. These groups seldom if ever have occasion to actually avail themselves of the program proper.

Second is the recruiting of groups of people who are sufficiently interested in

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the activities of the organization to desire to devote some part of their efforts as volunteer workers. Such service may take the form of work in the actual service program, in fund-raising operations, or in some other phase of the organization's activities.

Third is the publicizing of the program and the cultivation of the public for whom the service programs are intended. The success attained by the organization and the justification for its continuance are measured by the degree to which this particular objective is realized. This objective is further emphasized by the knowledge that on it rests the success of the first two objectives.

For most organizations these three objectives are closely interrelated and inseparable. The degree of success in achieving the objectives of the cultivation and education program is predicated on the effectiveness of the presentations to the public. In turn, the effectiveness bears some relationship to the expenditures available for that purpose, from the viewpoint of the organization. However, the attitude of the public toward expenditures not directly connected with the service program must also be taken into consideration. This is particularly applicable to the classification of fund-raising costs.

The Basic Problem of Organizations

As a public service, philanthropic organizations are expected to render an annual accounting of their stewardship. The accounting for the program generally takes the form of data showing activities and progress made. The accounting for the funds received during the year is presented in summary arrangement, showing income and expenses grouped in broad classifications.

Since this is the standard practice followed by publicly owned corporations, it would appear that the same standard, followed by philanthropic organizations, would also be acceptable to the public. This is not the case, however. In publicly owned corporation statements, the most important factor is the net profit earned and available for distribution in one form or another. The classification of expenses is secondary in importance. In reviewing reports by philanthropic organizations, the public is primarily interested in the manner in which funds contributed are expended.

In recent years, considerable attention has been focused by government committees on one particular item of expenditures, namely, fund-raising costs. Thus, the public's attention is directed principally to these costs and their relationship to the contributions received. This attention has not been considered detrimental by representative organizations. It has, however, emphasized the importance of correctly allocating costs between fund raising and public education inasmuch as these are so closely interrelated. Accountants serving the institutional field, publicly and privately, have recognized the importance of having some set of standards or principles which would adequately and properly cover the bases for allocations. To date, these are not available in a generally acceptable form. In the absence of such guidance, there now exist many interpretations covering the allocation of costs between fund-raising and public-education operations.

Definition of Fund-Raising Costs

Fund-raising costs comprise expenditures incurred for the primary purpose of securing financial support over and above the income derived from the service programs of the organizations. The scope is not restricted to specific fund-raising campaigns, but applies to the year-round fund-raising operations.

Definition of Public-Education Costs

This category of expenses forms the other phase of public support. The cost of public education comprises expenditures incurred for the primary purpose of publicizing the service programs and activities of the organization. As such, it also includes educational phases such as mass education projects.

Principles of Allocation of Fund-Raising Costs

As simple as these definitions may appear to be in text, the application of each gives rise to multiple interpretations. This situation can be met by the establishment of well-defined principles, sufficiently elastic to permit some reasonable latitude to meet special conditions characteristic of each type of organization.

Separation of Public-Support Costs

In view of the fact that fund-raising costs and public-education costs are so closely interrelated, some organizations combine both under one title, both for the record and for the published data. It should be recognized that reports achieve their most effective purposes when presented from the viewpoint of the persons for whom they are intended. For many reasons the public is interested in knowing the relationship between the cost of fund raising and contributions received. Thus, any data which merge these costs with other costs, irrespective of how closely associated they may be, would create an erroneous and a detrimental impression. Any endeavor to separate these costs on the part of the public would only be arbitrary and colored by the person's experience or inclination. For uniformity of reporting by organizations, and for clarity of presentation to the public, fund-raising costs and public-education costs should be separately reflected.

Allocation of Costs

Characteristic of philanthropic organizations is the fact that expenditures cover multi-purpose activities. This is especially so with fund-raising costs and public-education operations, which are so closely interrelated. It thus becomes essential to formulate some principle of allocation which would apply to large organizations whose resources permit separation of services by departments, and to smaller organizations where personnel perform multiple services and expenditures are combined for reasons of economy.

Fundamentally, an acceptable principle of allocation of costs would be one which provides for charge to that category of expense which best reflects the *primary purpose* or principal intent underlying the expenditure. Other collateral benefits or advantages accruing should be relegated to secondary importance and disregarded for purpose of allocation inasmuch as the expenditures would have been incurred in any event for the particular primary purpose.

Application of Principles

Inasmuch as this presentation is not intended for use as a manual of operations, all possible variations or exceptions cannot be included herein. However, the principles are applied to the major items of public-support expenditures in the knowledge that any exceptions or unusual conditions can be fitted into the scope covered by the principle by reasonable and proper interpretations.

Salaries

The necessity for allocation of salaries arises particularly with those organizations which obtain the principal financial support from direct public solicitation. In large organizations, a

year-round fund-raising department or service is maintained, supplemented by special personnel employed during campaigns. In smaller organizations, personnel perform multiple services including fund raising. Allocation of salaries is a negligible factor with organizations deriving the principal financial support from community or similar type campaigns. Salaries charged to fund-raising costs comprise those of staff personnel (full time or part time) whose primary assignments and services are directly related to fund-raising activities of the organization. In large organizations departmentalized by services, this category includes the director, his staff assistants and the clerical staffs related to the solicitation and the processing of contributions and related records. In smaller organizations, where personnel perform multiple operations, salaries are allocated to fund-raising costs as indicated in the following discussion.

For personnel, full time or part time, employed specifically to work in more than one service of the organization, salaries are allocated on the basis of division of time. This division may be determined by either of two methods. The first method involves an actual record of time spent on each service. Monthly, allocation of costs is made on the payroll records showing amounts chargeable to each service. The second method is the determination of a basis of allocation at the beginning of each fiscal year, based on prior year's experience and current conditions. Payroll allocation is the same as used in the first method. For example, the full-time services of an employee may not be required for the camping program of the organization. Employment is predicated on four months' work in fund raising, four months' work in public relations and four months' work in camping. Under this predetermined basis, the annual salary of the employee would be chargeable to each of these services in equal amounts. It should be noted that the time element only determines the amount to be allocated. The principle of primary purpose of allocation remains the same, i.e., employed to perform specifically in different services.

At this point, it becomes important to differentiate the above classification of employment from other types of employment involving the services of full-time, year-round personnel. In large organizations, the professional staff is only responsible for the service programs and activities of the organization. Where the professional personnel participate in fund-raising campaigns, such work is secondary in purpose. It is recognized that without this assistance the campaign activities would be affected. Nevertheless it is also recognized that the assignment to fund-raising work is not part of the primary work of the staff, but is handled in conjunction with their regular service program activities. Under the principle of primary purpose, no allocation of the salaries is proper.

The same principle can also be applied to the salary of the executive director of the organization. Whether the organization is large or small, the position is primarily administrative. In that capacity, he is responsible for the over-all supervision of all activities, of which fund raising is one. At certain times of the year one phase or another may require more attention. However, the over-all administrative supervision is never relinquished. Thus, no allocation of his salary is proper.

The question may be raised as to allocation of accounting department salaries (and other costs) to fund-raising operations. The preparation of bank deposits of contributions and issuance of contributors' receipts may consume a

considerable amount of time of the accounting personnel. The accounting department's responsibility is not fund raising but the exercise of sound internal control over all financial operations of which fund raising is one phase. The work of preparing bank deposits and issuing receipts come under the category of internal control. Thus, no allocation of accounting department costs is proper.

As a general consideration, wherever allocation of salaries is necessary, distribution should be recorded in the current period's payroll records. Postings to expense classifications should be made at the close of each current accounting period in order to reflect the proper relationship of expenditures to the related approved budget.

Allocation of social security taxes, group insurance, hospitalization, and other fringe benefits to employees should be made on the same basis used for salaries to which they relate.

Printed Materials and Mailing Costs

In this classification are included all printed or other reproduced releases used directly in fund-raising operations. This includes brochures, direct mail pamphlets, other pamphlets used in solicitation work, and forms and records used in solicitation, accounting for and processing contributions received. These materials may also include some public-education information. The extent to which both types of data are included is dependent on the purposes which the organization wishes to accomplish. It thus becomes a matter of proper application of the principle of primary purpose to each type of release.

We can begin an analysis of materials by charging to fund-raising costs all materials the contents of which are primarily intended as fund-raising appeals. These materials are prepared for exclusive use during campaigns or as regular or special appeals during the year for new or special gifts, pledge payments, or renewal of prior year's contributions. A second group of materials chargeable to fund-raising costs comprises solicitation forms, report envelopes, instructions to finance workers, and record and statistical forms used in the processing, recording and accounting for contributions. Included under this classification are also special printed forms used in tabulating or electronic equipment. The remaining items represent materials the allocation for which gives rise to varied interpretations.

As indicated in the opening section of this article, the objectives of the cultivation program are closely interrelated for both public education and fund raising. Typical of the many releases falling in the debatable area is the annual report. The publication of an annual report appears to be generally accepted as standard practice for philanthropic organizations. The annual report may be brief or elaborate depending on the budget available. It may contain direct or implied appeals for contributions. It may be timed for release during fund-raising campaigns. It may be released with a special insert representing an appeal for gifts. The foregoing indicate only some of the complications which may arise in determining how such costs shall be allocated.

The purpose of an annual report is to present an accounting of the stewardship covering the financial and functional operations for the current year ended. The report thus serves a dual purpose. Firstly, under the New York State Membership Laws, the board of directors are charged with the responsibility of presenting an annual report to the membership covering all operations. Secondly, the organization receiving public funds is charged with

the responsibility of accounting for them to the public. This is not a legal responsibility, but a moral one. It can readily be observed, therefore, that the primary purpose served by an annual report is public education, notwithstanding that a collateral benefit results from the fact that public acceptance may produce greater financial support. Irrespective of what other purposes the report may serve, as for example its circularization during fund-raising campaigns, all costs of preparing and mailing are proper charges to public education and not fund raising.

The costs of preparing and stuffing special enclosures appealing for funds are, however, fund-raising expenses. Where both are mailed as a single release, the mailing costs are chargeable to fund raising. With smaller organizations, limitation of funds make it more economical to prepare an annual report in such form as to serve both purposes. Under these conditions the annual release serves two primary purposes, i.e., fund raising and public education. The costs are therefore allocated to both classifications of expense.

Pamphlets and other releases explaining or instructing the public on the use or value of the service programs available are primarily intended as public education. The costs are therefore chargeable to public education only. Any reference to a contribution is of secondary although useful benefit.

Other Publicity Materials

These costs fall into two major groups. One group comprises publicity and public relations expenses intended primarily to bring the activities of the organization to the attention of the public. These costs are proper charges to public education. The second group comprises publicity and public relations intended primarily to keep the name of the organization before the public, principally during the fund-raising campaign periods. The costs included in this second group cover such items as radio and television spot announcements, newspaper and other media space, street and subway car cards, outdoor sign posters, motion picture trailers and other similar media. All of these simply show the name of the organization with a one or two word appeal for funds. These expenses therefore are properly chargeable to fund-raising expenses.

It will be noted that motion pictures are not included in the second group of expenses covering publicity and public relations. Generally, films are produced primarily to publicize some phase or phases of the service programs of the organization. The end purpose is to induce a greater use of the particular service covered. This is another aspect of the year-round cultivation program whose primary purpose is education. During fund-raising campaigns these films may be exhibited to attract both operating and capital contributions. This phase, however, is secondary in purpose. On the basis of its primary purpose, the costs are chargeable to public education only, or to a specific service program, where so budgeted. An example is a summer camp film exhibited during the year to cultivate increased paying camper attendance. Although used during fund-raising campaigns as a basic selling point of the over-all program of the organization, the costs are chargeable to the camping budget, or public education.

Costs of Special Functions

Fund-raising functions may be classified into three major groups, namely, dinners or luncheons, theatre or special events parties, and merchandise sales. These functions, although approved by the organization, are usually conducted

under the independent auspices of the sponsoring groups working on behalf of the organization.

Dinners and luncheons are held for the primary purpose of attracting and obtaining contributions. Gifts received are acknowledged to the donors at full value. In addition an admission charge is made to cover the direct costs of the meeting. All direct costs incurred by the sponsoring group are offset against the admission charges received. All expenses incurred by the organization in connection with the function, irrespective of how paid, are proper charges to fund-raising costs.

For special events and theatre parties, the net proceeds to the organization is the balance remaining after all direct costs incurred by the sponsoring group have been deducted. For theatre parties, the balance generally represents the sale of tickets, less the actual price paid to the theatre. Expenses incurred by the organization in connection with these events or parties are chargeable to fund-raising costs.

For rummage sales, bazaars and other similar functions where donated goods are sold, the sponsoring groups pay all costs. The organization only records as income the net proceeds received.

Organization Dinners and Meetings

This classification includes dinners, luncheons and other meetings, inspirational in scope, held by the organization for the purpose of stimulating volunteer workers engaged in campaign work. They also serve as report meetings. Where participants help to defray the costs of these functions through voluntary donations made at the functions, the amounts are applied as reductions of the costs incurred. They are not considered to be income.

Rent of Premises and Light

Space occupied by the year-round fund-raising service or department is charged to fund-raising costs on the basis of square feet occupied. However, space temporarily assigned during campaign periods is not allocated, but is charged to the service using the premises regularly. Expenses incurred in connection with premises donated on a free rental basis during campaign periods are charged to fund-raising costs. Charges for light are allocated on the same basis used for rent. All allocated expenses are distributed to fund-raising costs monthly for budget comparisons.

Telephone and Telegraph

For the year-round fund-raising operations, cost is allocated on the basis of number of extensions regularly assigned to the service. Additional extensions or trunk lines added during the campaign periods are direct charges to fund raising. Where switchboard control is operative, additional calls may be readily ascertainable and allocated. Under other conditions, past experience on increased costs during campaign periods may be used as a basis for allocation. Telegraph charges are readily determined from copies of messages transmitted.

Central Services Expenses

This classification of expenses does not refer to the costs incurred by fund-raising agencies on behalf of participating organizations. It is a classification of expenses characteristic of large organizations. For economy in operations and for more efficient services, one central service bureau within the organization is set up to handle stenographic, clerical and messenger services, mimeograph, offset and other reproducing processes, operation of electronic equipment and similar services.

The allocation of these costs to fund-raising and other departments is based on the usage made of these services at rates predetermined annually, at the beginning of each fiscal year. Stenographic, clerical and messenger costs are allocated on the basis of time records, summarized monthly. Mimeograph and other reproducing process costs are allocated on the basis of requisitions submitted by each department. Rental of equipment is allocated on the basis of time usage. Salaries involved are allocated in accordance with the basis used for the other related costs. Distribution of expenses to the various departmental costs is made on a monthly allocation basis.

Generally Accepted Accounting Principles

"Generally accepted" does not mean that the principle is best; or, even, that it is better than others; or that it is logically and objectively derived; or that it is necessarily most useful at all times. All the term means is, literally, what it says: enough persons have adopted it to ensure its acceptance—in other words, so many people are in the same boat, that if you adopt the principle you will not be lonely.

There seem to be no criteria, of an objective kind, for selecting the best of the generally accepted accounting principles. If assumptions and conditions are stated—if it is precisely specified for what the accounting is wanted—a set of principles can be designed that will best serve that purpose. Then, as the assumptions and conditions and needs change, the principles must also change. But the real world is rather different. Accounting has developed over the years with a desire for stability, durability, certainty and general applicability, regardless of the emphasis placed in the literature on "usefulness," "an art rather than a science," and "changes to meet changed conditions."

Here, in part, is the explanation of the confusion and perplexity resulting from changes in the purchasing power of money. Up to now, historical cost has continued to be the generally accepted basis for accounting, and it is supported by all important accounting bodies. Admittedly, the fact that in most advanced countries the pace of inflation has in recent years been moderate has weakened the drive for change. . . . To affirm that inflation has not been severe or abrupt enough to require changes in historical cost accounting is another way of saying that the distortion of reports has not been significant enough to call for a shift from the historical cost basis for long-lived assets. But the admission of distortion is, in itself, serious. Those who argue that correct accounting and the historical cost principle are identical twins are on firmer ground, for they deny that there is a distortion, refusing to associate the determination of income with either the replacement problem or the purchasing power concept. I find a certain dignity in their position, for an income figure arrived at by their route undoubtedly has about it the quality of objectivity in maximum degree; the figure is simply stated and no need to defend it is recognised. . . .

B. C. Lemke, "The Development of Accounting in the United States,"
Accounting Research, October 1957

Official Release

Earnings per Share

Issued April 1958 as Accounting Research Bulletin No. 49 by the Committee on Accounting Procedure, American Institute of Certified Public Accountants.

1. Statistical presentations of periodic net income (or loss) in terms of earnings per share[1] are commonly used in prospectuses, proxy material, and annual reports to shareholders, and in the compilation of business earnings statistics for the press, statistical services, and other publications. This bulletin deals with a number of problems arising in the computation and presentation of such statistics.

2. The committee has previously considered certain aspects of this matter[2] and now reaffirms its earlier conclusions that:

(a) It is, in many cases, undesirable to give major prominence to a single figure of earnings per share;

(b) Any computation of earnings per share for a given period should be related to the amount designated in the income statement as net income for such period; and

(c) Where material extraordinary charges or credits have been excluded from the determination of net income, the per-share amount of such charges and credits should be reported separately and simultaneously.

3. Not only does the use of a single figure for earnings per share involve the same limitations of usefulness as does a single figure for net earnings, but also, in many circumstances, the computation of earnings per share involves unique problems. While it is desirable to achieve as much uniformity as is feasible, clear explanation and disclosure of methods used are especially important in this area of financial reporting.

4. The committee suggests the following general guides to be used in computing and presenting earnings per share:

(a) Where used without qualification, the term *earnings per share* should be used to designate the amount applicable to each share of common stock or other residual security outstanding.

(b) Earnings per share, and particularly comparative statistics covering a period of years, should generally be stated in terms of the common stock position as it existed in the years to which the statistics relate, unless it is clear that the growth or decline of earnings will be more fairly presented, as for example, in the case of a stock split, by dividing prior years' earnings by the

[1] As used herein, the term *earnings per share* connotes either earnings or losses per share.

[2] Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins* (1953), Chapter 8, par. 14. Also see Chapter 2(b), par. 4.

current equivalent of the number of shares then outstanding.

(c) *In all cases in which there have been significant changes in stock during the period to which the computations relate, an appropriate explanation of the method used should accompany the presentation of earnings per share.*

Single-Year Computations

5. In the computation of earnings per share for a single year, minor increases or decreases in the number of shares outstanding during the year may be disregarded, and it is appropriate to base the computation on the number of shares outstanding at the end of the year. In the case of a substantial increase or decrease in the number of shares resulting from the issuance or reacquisition of stock for cash or other property during the year, it is generally appropriate to base the computation of earnings per share on a weighted average of the number of shares outstanding during the year. Where there has been little or no opportunity to utilize the proceeds from the issuance of such shares, as would most clearly be the case when the shares were issued shortly before the end of the year, such shares may be disregarded in the computation. When an increase in the number of shares outstanding results from a stock dividend or a stock split, or a reduction in the number of shares outstanding results from a reverse split, without proceeds or disbursements, the computation should be based on the number of shares outstanding at the end of the year. For purposes of determining the number of shares outstanding, reacquired shares should be excluded.

6. If there has been a stock split[3] or a reverse split after the balance-sheet date but before the issuance of the financial report, it is desirable to base the computation of earnings per share on the new number of shares, since the reader's primary interest is presumed to be in the present stock position. Similar considerations may apply to stock dividends,[3] although a relatively small stock dividend may properly be disregarded. In these cases of changes after the balance-sheet date, it is preferable to choose the more useful and informative basis of computation rather than to present two simultaneous and possibly confusing computations on different bases. When computations of earnings per share reflect changes in the number of shares after the balance-sheet date, it is important that this fact be clearly disclosed since there may be a presumption that earnings per share are based on the number of shares shown on the balance sheet. It is equally important that significant changes in the number of shares after the balance-sheet date be disclosed when such changes are not reflected in the computation of earnings per share.

7. Where there are shares outstanding senior to the common stock or other residual security, the claims of such securities on net income should be deducted from net income or added to net loss before computing per-share figures, since the term *earnings per share* is ordinarily used to designate the amount applicable to each share of common stock or other residual security outstanding. In arriving at net income applicable to common stock for purposes of the per-share computations, provision should be made for cumulative preferred dividends for the year, whether or not earned. In the case of a net loss, the amount of the loss should be increased by any cumulative preferred stock dividends for the year. Where such dividends are cumulative only if

[3] See Accounting Research Bulletin No. 43, Chapter 7(b).

earned, no adjustment of this nature is required except to the extent of income available therefor. In all cases the effect that has been given to dividend rights of senior securities in arriving at the earnings per share of common stock should be disclosed.

8. The following special considerations relate to convertible securities:

(a) When debt capital, preferred stock, or other security has been converted into common stock during the year, earnings per share should ordinarily be based on a weighted average of the number of shares outstanding during the year. When the weighted average is used in such cases, adjustments for the year in respect of interest or other related factors are not made.

(b) When capitalizations consist essentially of two classes of common stock, one of which is convertible into the other and is limited in its dividend rights until conversion takes place as, for example, when certain levels of earnings are achieved, two earnings-per-share figures, one assuming conversion, are ordinarily necessary for full disclosure of the situation.

Comparative Statistics

9. Presentations of earnings-per-share data for a period of several years should be governed basically by the criteria for single year presentations, but may involve a number of special considerations in view of changes in conditions during the period, and the purpose for which the data are to be used. It should be recognized that any tabulation of earnings per share for a period of years may have little bearing on the present position, and may fail to give any indication of present expectations. Variations in the capital structure may have substantial effects on earnings per share. The usefulness of such statistics depends in large measure on collateral historical information and disclosure of methods of computation used. The committee's recommendations which follow are intended as guides to general uniformity but not as substitutes for explanations and disclosures or as cures for the inherent defects in statistical presentations of earnings per share.

10. When computations of earnings per share for a period of years, such as are submitted in annual reports and in prospectuses, include periods in which there have been stock splits or reverse splits, the earnings for periods prior to the dates of the splits should be divided by the current equivalent of the number of shares outstanding in the respective prior periods in order to arrive at earnings per share in terms of the present stock position. Similar treatment should be accorded to stock dividends; however, it is permissible not to extend such treatment to small recurrent stock dividends, although in a prospectus or when such dividends in the aggregate become material, consideration should be given to recognizing the cumulative effect thereof. On the other hand, where, during the period of years for which data are given, there have been issuances or reacquisitions of stock for cash or other property, or, issuances in connection with conversions of debt capital, preferred stock, or other security, the computations of earnings per share for the years prior to such changes are not affected; it follows that earnings per share for these years should be based on the number of shares outstanding in the various years. When both situations have occurred, the effect of each should be reflected in accordance with the foregoing recommendations.

11. When equity securities are being publicly offered:

(a) If there have been significant conversions of debt capital, preferred

stock, or other security during the period of years for which data are given, it is appropriate to present supplementary calculations revising past figures to reflect subsequent conversions, on a pro forma basis.

(b) If the securities being offered, or their proceeds, are to be used to retire outstanding securities in circumstances which assure such retirement, it may be useful to present, in addition to otherwise appropriate calculations, supplementary computations to show pro forma earnings per share for at least the most recent year as if such substitution of securities had been made. When this is done, the basis of the supplementary computations should be clearly disclosed. Where, however, the securities being offered, or their proceeds, are to be used, not to retire existing securities, but for such purposes as expansion of the business, earnings per share should be computed without adjustment for any increase in the number of shares anticipated as a result of such offering.

12. Where there has been a pooling of interests[4] during the period of years for which data are given, in connection with which the number of shares outstanding or the capital structure in other respects has been changed, the method used in computing earnings per share for those years prior to the pooling of interests should be based on the new capital structure. When there is to be a pooling of interests in connection with which the number of shares outstanding or the capital structure in other respects will be changed, earnings per share for any period for which income statements of the constituent companies are presented in combined form should be computed on a basis consistent with the exchange ratio to be used in the pooling of interests. In either case earnings per share should, in all other respects, be computed in conformity with the principles set forth in the foregoing paragraphs.

Earnings Coverage of Senior Securities

13. Where periodic net income is related to outstanding shares of senior securities, such as preferred stock, the committee believes that, under most circumstances, the term *earnings per share* is not properly applicable in view of the limited dividend rights of such senior securities. In such cases it may be helpful to show the number of times or the extent to which the requirements of senior dividends have been earned, but such information should not be designated as earnings per share.

Miscellaneous

14. It is impracticable to deal, in this bulletin, with all of the possible conditions and circumstances under which it may be necessary or desirable to compute data in terms of earnings per share—for example, acquisitions, mergers, reorganizations, convertible and participating securities, outstanding stock options, retirements, and various combinations of these circumstances. While such situations should be dealt with in harmony with the recommendations made in this bulletin, they call for especially careful consideration of facts and the exercise of judgment in the light of all the circumstances of the case and the purposes for which the data are prepared. In such complex situations as those mentioned in this paragraph, a clear disclosure of the basis on which the computations have been made is essential.

(Continued on page 582)

[4] See Accounting Research Bulletin No. 48, *Business Combinations* (1957).

Recent Developments in New York State Tax Legislation and Regulations

By Stanley H. Beckerman, C.P.A.

The purpose of this article is to summarize recent New York State Tax legislation and regulations particularly as affecting the personal income tax.

Proponents of a federally-based New York State personal income tax received added ammunition from the results of the special session of the New York Legislature in June 1957 and the regular session in 1958. Out of the mélange of numerous uncoordinated bills affecting personal income taxes, relatively few were passed and a still smaller amount were enacted into law. The relatively insignificant number of bills finally enacted represent another chapter in the patchwork pattern of piecemeal amendment of the law apparently without any clear pattern or order other than meeting the exigencies of the moment.

Sick-Pay Exclusion

The special session of the Legislature in June 1957 amended Section 359(2)(e) of the Tax Law to exclude from gross income amounts received by employees through health and accident insurance as reimbursement for medical care of the taxpayer, his spouse and dependents or payments for permanent loss of function or permanent disfigurement where the payments are determined by the injury and without reference to absence from employment. The amendment also excludes from gross income payments in lieu of wages during absence from work on account of personal injuries or sickness up to a maximum of $100 per week. The exclusion applies to payments after the first seven days of absence unless the employee is hospitalized for one day during the period of absence from work. This amendment conforms the State law to the exclusions provided by Section 105 of the Internal Revenue Code and was one of the legislative recommendations of the Committee on New York State Taxation of The New York State Society of CPAs.

The Regulations of the State Tax Commission issued under this section are designed to result in identical treatment of "sick-pay" exclusions for both State and Federal returns. Subdivision (d) of Article 83 of the State Regulations specifically provides for the applicability of the Treasury Department Regulations and interpretive rulings relative to the exclusions. This policy is being adhered to in practice as evidenced by a letter ruling of Mortimer M. Kassell, Deputy Commissioner and Counsel, Department of Taxation and Finance, dated April 16, 1958, in which adherence to the Federal Regulations

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relative to exclusions was reiterated and served as the basis of the ruling.

The new treatment is applicable to any taxable year commencing on or after January 1, 1957.

Employer's Contributions to Health and Accident Plans

The 1958 session of the Legislature took another look at Section 359 of the Tax Law and amended subsection 2 by the addition of paragraph (q) which provides that contributions by an employer to accident or health plans for compensation to his employees for personal injuries shall be excluded from the employee's gross income. The exclusion applies whether the compensation is through insurance or other means and was approved March 24, 1958 applicable to taxable years commencing on or after January 1, 1957.

Prizes and Awards; Scholarships and Fellowship Grants

In another set of amendments to Section 359, the Legislature resolved several areas of doubt while achieving conformity with the Internal Revenue Code. Section 359(1) was amended to provide that prizes and awards are includible in gross income except those received in recognition of religious, charitable, scientific, educational, artistic, literary or civic achievement where the recipient is selected on a non-competitive basis and is not required to render substantial future services in order to obtain the award. This amendment, applicable to taxable years beginning on or after January 1, 1958, is virtually identical with Section 74 of the Internal Revenue Code.

Paragraph (r) which was added to Section 359(2) exempts from gross income payments to matriculated students for scholarships and fellowship grants including the value of contributed services, accommodations and expenses incident to an exempt scholarship or grant to the extent expended by the recipient. The exclusion does not apply to payments for teaching, research or other services required to obtain the scholarship unless such services are required of all candidates for a particular degree. The exclusion does not apply to payments received by students who are not candidates for a degree unless contributions to the grantor of the scholarship are deductible as charitable contributions under the State Law. If payments to non-matriculated students qualify under the foregoing, the amount of the exclusion is limited to $300 times the number of months of payment up to a maximum of thirty-six months. Generally, this amendment conforms to Section 117 of the Internal Revenue Code.

Liquidating Distributions by Partnerships

For taxable years commencing on or after January 1, 1958, new Section 364-a of the Tax Law provides that payments in liquidation of the interest of a retiring or deceased partner representing such partner's interest in partnership assets shall be taxed as a sale or exchange of such interest. The balance of such liquidating payments are to be treated as distributions of partnership income.

Amounts paid for "unrealized receivables" and for goodwill of the partnership (except to the extent the partnership agreement provides for a payment for goodwill) are not to be included in payments representing a partner's interest in the partnership assets. "Unrealized receivables" are defined as the rights to payment for goods delivered or to be delivered to the extent that such payments would be treated as ordinary income from the sale of a noncapital asset, and the rights to payment for services rendered or to be rendered if such rights were not previously in-

cludible as income under the partnership's method of accounting.

Prior to enactment of this section, all amounts paid to a retiring partner were deemed in payment for his interest, resulting in capital gain or loss to the retiring partner and no deduction to the remaining partners. The new section appears to conform State law to Section 736 of the Internal Revenue Code. It should be noted that the State treatment on liquidation may not be entirely consistent with that of the Federal income tax as the State law has no provision comparable to Section 751 of the Internal Revenue Code which provides for ordinary income for the amount of gain on liquidation attributable to inventory which has "appreciated substantially in value."

Change from Accrual Basis to Installment Basis

Partial relief is granted to taxpayers who change from the accrual basis to the installment basis of reporting net income and net capital gain, effective for taxable years commencing on or after January 1, 1958.

As amended, Section 358-a of the Law continues the requirement that accrual basis taxpayers changing to the installment basis must again subject to tax, installments received on account of sales or other dispositions made in a prior year even though the entire gain was previously taxed on the accrual basis. However, under the new provision, taxpayers are granted a reduction in tax for the year of duplication of income equal to the amount of tax previously paid attributable to such income, but not in excess of the tax in the duplication year attributable to the receipt of the installment payments.

The amendment to Section 358-a also provides that for years commencing January 1, 1958 the installment method may be used for casual sales of personalty and sales of realty if there are no payments in the year of sale.

The aforementioned changes conform Section 358-a of the State Law to Sections 453 (b) and (c) of the Internal Revenue Code.

Exemption for Dependents Attending College

The $800 personal exemption for dependents in full-time attendance at approved schools or colleges first enacted in 1957 was broadened to eliminate the age requirement and to include business schools as eligible institutions. Prior to the amendment, the exemption was available only to dependents over 18 years old. The liberalized provision is available for taxable years commencing on or after January 1, 1958.

Credit for Income Taxes Paid Other States

The credit granted New York residents for personal income taxes paid to other states on income derived from such states, first granted in 1957, was extended by the Legislature to taxes payable on income for the calendar year 1957 or any fiscal year or period of less than one year ending in 1958. This credit is available only for taxes paid to states which do not allow a nonresident credit to New York residents and is designed to protect New York residents from double taxation.

The credit has been extended on a year-to-year basis primarily to protect New York residents working in Massachusetts which taxes nonresidents without credit for New York income taxes. If Massachusetts should in the future grant nonresidents a credit for income taxes paid to their state of residence, it is anticipated that the credit against New York tax will be eliminated.

Statute of Limitations

Chapter 403 of the Laws of 1958 amends Section 373 of the Tax Law to

increase from five years to six years the period within which the State Tax Commission may make additional assessments in cases where in excess of twenty-five per cent of the gross income or capital gain as reported was omitted from the return as filed. This change is effective April 1, 1958.

Miscellaneous

In addition to the foregoing, the following amendments were enacted.

1. A bill amending Section 360(10) to permit the deduction for personal income tax purposes of contributions or gifts to nonprofit cemetery corporations or associations for the improvement or upkeep of cemeteries.

2. Chapter 371 of the Laws of 1958 continued the reduction of unincorporated business tax of 15 per cent of the first $100 of tax and 10 per cent on the next $200 of tax for the calendar year 1957 and fiscal years or periods of less than one year ending during 1958.

Constitutional Amendment Re: Federal Income Base

A concurrent resolution of the Legislature adopted January 29, 1958 proposes that Section 22, Article 3 of the State Constitution be amended to adopt the federal definitions of income for purposes of state taxation of personal and unincorporated business income as well as corporation income. This proposal will have to be again approved by the Legislature in 1959 prior to submission to the electorate for approval.

Conclusion

Analysis of the amendments to the New York Tax law discussed in this paper indicates that most of the measures adopted were designed to bring New York law into conformity with the Internal Revenue Code. However, many areas remain in which differences between State and Federal treatment will continue to plague taxpayers and their representatives.

It is quite apparent from the foregoing analysis of the 1957-58 changes that the State law becomes increasingly complex through the continuing attempts at achieving conformity with the Federal Law. Hopeful signs that something fundamental may be accomplished to remedy this situation are the recommendations by the New York State Bar Association and the New York County Lawyers Association for a formal study of the feasibility of a federally-based New York State personal income tax, and the recent action of our State Society's Committee on New York State Taxation endorsing such proposal.

Earnings per Share

(Continued from page 578)

Dividends Per Share

15. Although this bulletin deals primarily with earnings per share, certain considerations may apply comparably to dividends per share. In general, dividends per share constitute historical facts and should be so reported. However, in certain cases, such as a stock split as mentioned in paragraph 10, a presentation of dividends per share in terms of the current equivalent of the number of shares outstanding at the time of the dividend is necessary so that dividends per share and earnings per share will be stated on the same basis. When dividends per share are stated on any other than the historical basis, it is generally desirable that such statement be supplemental to the historical record, and its basis and significance should be fully explained.

The statement entitled "Earnings per Share" was unanimously adopted by the twenty-one members of the committee.

New York State Tax Forum

Guest Editor—SIDNEY BLUMENBERG, C.P.A.

From the inquiries and items directed to the attention of our Society's Committee on New York State Taxation during the past year, the following have been selected as having some general interest and application.

Partnership Period

A partnership was on a fiscal year basis ending October 31. In the middle of November 1955 the partnership filed a petition in bankruptcy and was adjudicated a bankrupt. For the period starting November 1, 1955 to the date of the filing of the petition a considerable loss appears to have been sustained. The question raised was as to whether a partner was to report the loss attributable to him on his 1955 or 1956 return. The State advised the inquirer that losses by a partnership after the end of the taxable year and before the partners' corresponding taxable year should be accounted for by both the partnership and the partners in their returns for the next succeeding taxable year. Therefore, if the partnership loss occurred subsequent to October 31, 1955, then the loss determined in November 1955 may be claimed on the 1956 individual returns of the member partners.

In connection with this question of partnership periods, it should be noted that the New York State Tax Law (Sec. 364) and the Regulations (Article 229) were amended in 1957 to provide that "in the case of a sale, exchange, or liquidation of a partner's entire interest in a partnership, on or after July 1, 1957, the partner shall include in his taxable income for his taxable year within which his membership in the partnership ends, his distributive share of the net income or net loss and net capital gain or net capital loss ending with the date of such sale, exchange, or liquidation. The death of a partner does not constitute a liquidation of his entire interest in a partnership."

Goodwill

Is the amount received for goodwill on the sale of a route, such as a vending or window-cleaning route, subject to capital asset treatment? The sale of goodwill is controlled by Article 487-g of the Regulations. This provides that gain or loss on goodwill is the difference between the sales price and proven cost or other basis. If specific payment was not made for goodwill acquired on or after January 1, 1919, no deductible loss is possible, although, on the other hand, upon the sale of the business there may be a profit. Goodwill is a capital asset for both state and federal tax purposes.

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ED. NOTE: For an interim period, until a permanent departmental editor has been selected, this department will be conducted by guest contributors.

Sale of Realty by an Unincorporated Business

If a partnership composed of nonresident partners, owning a rooming house in New York, sells the rooming house, is the resulting gain subject to unincorporated business tax? The Regulations indicate that income from the sale of the assets associated with a taxable business would be taxable. It would appear, however, that if the partnership dissolved and distributed its assets, including the rooming house, to the partners, that they, individually, or through a common agent or representative, might sell their respective interests in the assets without becoming subject to the unincorporated business tax.

Two or More Businesses Owned By One Entity—Unincorporated Business Tax Effects

A recurring question, arising out of different fact situations, is the unincorporated business tax effect of the conduct of separate business activities by one individual or entity. Related to this is the problem of exemptions and allowances for personal services. Article 2 of the Regulations deals with some aspects of these problems. It points out that where the same entity operates two or more unincorporated businesses, the operating results are required to be consolidated. Only one exemption may be taken and one allowance made for the personal services of the individual or partners conducting the businesses.

Under some circumstances, the Regulations indicate that certain income may become subject to the tax which would not otherwise be within its scope. For example, the leasing out of a portion of premises owned by a manufacturing business, to an unrelated business, results in rental income subject to the unincorporated business tax, although the holding, leasing, or management of real property, by itself, would not have resulted in income subject to the tax. The Regulations, in this respect, appear to be inconsistent with the results obtained in *Voelkel* v. *Browne* (1-2 NY Tax Cases 718; 268 App. Div. 596, aff'd no op., 294 N.Y. 834). In that case the court found that where the owner of a manufacturing business and of 81 pieces of real property kept separate records and bank accounts for the business and the property, and charged the business rent for use of some of the property, the activity relating to the management of the property was not subject to the unincorporated business tax. One can only speculate as to whether the maintenance of separate records and accounts is the basic reconciling factor in these opposite results.

Of course, the utilization of separate partnerships or entities, generally provides a solution to this problem. This gives rise to separate exemptions and separate allowances for personal services. In this connection, it is noteworthy that if a husband and wife carry on separate businesses, each business is a separate entity, requiring separate returns. One additional thought on the separate and distinct nature of the unincorporated business is that the filing of a personal income tax return does not constitute the filing of an unincorporated business tax return. Accordingly, the statute of limitations does not begin to toll until the latter return is filed.

Decedents and Taxes

It should be noted that the optional deduction of 10 per cent of gross income or $500, whichever is less, in lieu of all deductions otherwise allowable, is not available to estates or trusts. Also, the State does not permit a surviving spouse to file a joint return with the deceased for the taxable year in which the death of the decedent occurs.

Inquiry has been made as to whether it is necessary to wait until the expira-

tion of the year in which the death of the taxpayer occurs, in order to file a return for the decedent's last taxable period. Article 542 of the Regulations provides: "An executor or administrator shall file a return for the decedent for that portion of the decedent's taxable year prior to the date of his death. Such return may be filed at any time after the appointment and qualification of the executor or administrator and without waiting for the close of the taxable year."

Miscellaneous State Tax Committee Notes

Conformity of federal and state law. The Committee on New York State Taxation added its support to the effort being made to conform the state tax law with the federal tax law. It voted its endorsement of the constitutional amendment passed by the Legislature at its recent session which has this objective.

The unincorporated business tax and small business. Several months ago, Sidney H. Rand, CPA, wrote a letter to the editor (May 1958 issue) and thereafter communicated with the Committee, calling attention to an apparent inequity suffered by the small businessman in the application of the unincorporated business tax. He pointed out that in certain lower income brackets the individual operating an unincorporated business paid more tax than the incorporated business, although the latter entity enjoyed a number of legal advantages. The Committee has reviewed this situation and has suggested that a re-examination of the allowance for the personal services of individuals operating an unincorporated business might adjust this situation. This approach will be discussed with the State Tax Commission.

Reproduction of tax returns. An effort is being made to clarify the questions incident to the acceptable reproduction of tax returns for filing with the state. To this end, it would be appreciated if copies of correspondence received by practitioners, bearing on the acceptability or non-acceptability of reproduced tax returns, or any official information thereon, were forwarded to our Committee on New York State Taxation in care of this magazine, so that all available information may be collated for the general guidance of all concerned.

Administrative or procedural recommendations. It is expected that the Committee will meet shortly with the State Tax Commission for a discussion of proposed administrative and procedural changes. Accordingly, any readers who have suggestions in these areas, are invited to forward them to us for review and submission.

Educating the Client

...It is a fact, however, that all too often the banker has the unpleasant duty of telling his customer that the figures submitted are not entirely satisfactory—to the embarrassment of banker, borrower and accountant.

In view of the excellent progress that has been made in achieving better understanding of mutual problems between bankers and accountants, it would seem that the way to avoid such embarrassment lies in better education of the borrower, since he ultimately determines the scope of the accountant's engagement. Certainly it is up to the banker to be explicit in outlining to his customer the type of report he requires, but thereafter the burden is on the accountant: he knows what a banker normally wants, and if he has any difficulty with his client, I am sure he will find the banker more than willing to discuss the problem with borrower and accountant together.

CHARLES E. LORD, "Accountant, Banker and Borrower,"
THE CONNECTICUT CPA, March 1958

Accounting at the SEC

Conducted by Louis H. Rappaport, C.P.A.

The Short-Form Prospectus

In the early days of the Securities Act, the preparation of a registration statement was even more complicated than it is today. The registration process years ago also involved a great deal of duplication which fortunately is not true today.

When the SEC took over the administration of the Securities Act from the Federal Trade Commission, it continued the use of Form A-1 which was then in effect as the basic registration form. Shortly thereafter the SEC promulgated a new and additional registration form—called Form A-2—for use only by seasoned companies that complied with the requirements for its use.

Forms A-1 and A-2 had some things in common. Under both forms the registration document had to be complete in every respect, and in addition required the preparation of a prospectus which duplicated much of the information that was contained in the registration statement itself. At the time, this duplication seemed regrettable but necessary. The investor's chief interest is the prospectus because that is the document on the basis of which he ordinarily makes up his mind whether or not to buy the security being offered.

Louis H. Rappaport, C.P.A., *a partner in the firm of Lybrand, Ross Bros. & Montgomery, C.P.A.s, is the author of* SEC Accounting Practice and Procedure.

The SEC rescinded Forms A-1 and A-2 and adopted other forms to replace them. The new forms were designated S-1, S-2, etc. Form S-1 is the one used most often. It consists of two parts: Part I is the information that must be included in the prospectus; Part II consists of information that need not be included in the prospectus. Consequently we no longer have the duplication of material because the prospectus has become a basic part of the registration document.

As a result of a change in 1954 in the Securities Act and the adoption by the SEC of new rules and instructions, there has come into use on a restricted basis a short form of prospectus called a "summary prospectus." This prospectus is a highly condensed version of the complete (or long-form) prospectus and is intended to facilitate the dissemination of investment information and to aid in screening potential buyers of the security who would be interested in obtaining the long-form prospectus. The use of the short form is optional. It does not replace the complete prospectus which still must be furnished to the buyer of the security. Every summary prospectus carries the following legend:

> Copies of a more complete prospectus may be obtained from (insert name or names).

A short-form prospectus usually consists of about four pages and gives the most significant information about the company, its operations, products and

earnings. The summary of earnings is the only financial statement required to be included in the short-form prospectus when used in relation to an S-1 filing. The financial requirements are slightly different in the case of a filing on Form S-9 which is used to register debt securities of high grade issuers.

Customarily, the summary of earnings in the short form prospectus is preceded by a headnote which indicates that it is taken from the complete prospectus and that it is certified by the independent accountants whose report appears in the complete prospectus. Because of space limitations, the accountant's certificate ordinarily is not included (and is not required to be included) in the summary prospectus.

As far as accountants are concerned there are a few things to be kept in mind in connection with the use of summary prospectuses.

If there are notes to the financial statements in the long-form prospectus which are essential to an understanding of the earnings summary, these notes should be furnished as a part of the earnings summary in the short-form prospectus. From the viewpoint of the investor reading the short prospectus, if a note is essential to an understanding of a financial statement, the note should be included in the prospectus.

If the earnings summary in the short-form prospectus is "expertized" (i.e., submitted in reliance upon the accountant's certificate and his authority as an expert) but the accountant's certificate is not furnished, the accountants, in their certificate in the complete prospectus, should cover the earnings summaries in both prospectuses. This may be accomplished by writing the accountant's report along the following lines:

> We have examined the (identified financial statements) of ....Company and the earnings summary contained in this prospectus and in the summary prospectus. Our examination, etc. . . .
>
> In our opinion, the (identified financial statements) present fairly the financial position of ....Company at (date) and the results of its operations for (period), and the earnings summary contained in this prospectus and in the summary prospectus presents fairly the net income and other data shown therein for (period), all in conformity, etc.

If the earnings summary is furnished in sufficient detail so that it constitutes an income statement, and if information regarding changes in earned surplus is given, the accountant may report that the earnings summary "presents fairly the results of operations, etc."

When making arrangements for an SEC engagement, the accountant should inquire whether the company or the underwriters intend to prepare and circulate a summary prospectus. The short form is currently used by relatively few companies. Inasmuch as the short-form prospectus does not ordinarily contain a certificate, sometimes the prospectus is prepared without the accountant's knowledge, in which event it comes to his attention as the result of a comment in the SEC's deficiency letter. Certainly it is better to know these things in advance and thereby avoid the deficiencies.

Administration of a CPA Practice

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by MAX BLOCK, C.P.A.

Gleanings From Our Society's 1958 Annual Conference

Compliance with Bulletin No. 23

Compliance with the provisions of the AICPA's Statement on Auditing Procedure No. 23 received considerable attention, and deservedly so. Since the provisions have been approved by the N. Y. State Society of CPAs, with the expectation that the members as well as all practicing accountants would conform, the discussion had a direct interest for those present.

Two major problems were given consideration. First was the failure on the part of a segment of the profession to take a position, as required, regarding financial statements submitted by them. Second was an apparent inclination by some practitioners to disclaim an opinion though in some cases a qualification would be permissible and, in other instances, to fail to bring out the positive factors in the audit and the financial statements.

An omission of a required procedure requires a disclaimer of opinion only if the amount involved is material and the auditor has not satisfied himself otherwise by procedures which, in his opinion, are demonstrably satisfactory. There is some latitude in this permissive provision. Moreover, the opinion paragraph may be expanded to bring out the positive factors of the adequacy of the audit "in all other respects" and that, whereas the disclaimer applies to the statements "as a whole", not all aspects of the statements are "tainted" by the omission of the specified audit procedure. Compliance with the provisions of Bulletin No. 23 is in the best interests of the profession. Many failures, in this writer's opinion, are due to an erroneous concept as to the inflexibility of the requirements. Literature on the subject not alone clarifies this point but provides many illustrations of clauses that temper the seeming rigidity.

Accountants' Legal Liability for Malpractice

This subject is one as to which there is as yet an inadequate body of cases that clearly define an accountant's responsibility to his client and to third parties. The few existent cases are affected by conditions peculiar to them

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and are largely old. Changing conditions and attitudes may make the old decisions uncertain as to their reliability in new judicial actions. There are safeguards which practitioners should be ever mindful of. Briefly, they are the following:

1. An understanding should be reached with the client, evidenced in writing, as to the limitations of the audit with respect to employee and customer frauds.

2. The client company's internal control should be inquired into and the evidence thereof should appear in the workpaper file.

3. Inadequacies in internal control should be communicated to the client and the workpapers should disclose the effect on the audit program of the awareness of the deficiencies.

4. The workpapers and the financial statements should reflect compliance with auditing and reporting standards and that the opinion, if any, is properly founded. Where no opinion is expressed and the report does not specifically disclaim an opinion, the accountant will not necessarily derive immunity against claims because of this omission.

5. Adequate liability insurance should be carried.

Claims against accountants are more frequent than commonly realized and, particularly where reliance is placed on staff, no one is immune, large firm or small firm. Constant alertness to this hazard is basic to the preservation of reputation and fortune. Good administration of a practice will make this a cardinal principle. Practitioners would serve themselves well by reading the material on this subject by Saul Levy in the CPA HANDBOOK, and in articles by him which have appeared in THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT and THE JOURNAL OF ACCOUNTANCY.

Firms' Standards and Staff Retention Problems

An intelligent, alert and forward-looking accountant will not be content to stay long on a job if he is dissatisfied with a firm's standards and practices. He will be on the lookout for a better position as soon as he realizes that he will not improve his technical knowledge and acquire worthwhile experience on the job. Moreover, he feels that his chances for obtaining a better position are increasingly diminished the longer he stays with a firm whose auditing and reporting standards are subnormal. Employers should recognize this factor as one that has a vital bearing on the ability to retain good staff accountants. Many men will make some sacrifice of compensation to obtain good experience.

Graduates seeking employment are naturally interested in connecting with "good" firms. Some immediately turn to the large firms as insuring the best experience and progress. Others seek to be placed with the medium-sized firm having high standards, as the firm offering good, all-round experience. Many graduates inquire about the "good" firms from their accounting instructors and from friends in the field. Thus, many graduates are informed as to the firms to be approached first, and only after failing there will they move into the lower echelon.

What about the practitioner whose clients are very small businesses, where the services rendered are largely of a write-up nature and where compliance with auditing and reporting standards is unfortunately uneconomic? He will always have a problem in obtaining good accounting help, the severity of which will vary with employment conditions. Even such practitioners could face their problems realistically and, despite the limitations of their practice,

help the staff accountant derive as much out of his work as is possible. Such positions provide early opportunities to be in charge, to deal with clients, to learn bookkeeping techniques of business, to get valuable experience in developing accuracy and mathematical facility, and to render a real, constructive service to small businessmen.

Small businessmen need statements for credit purposes as well as for managerial guidance. Here is an opportunity for observance of auditing and reporting standards. The discussions with clients of their business and personal problems is educational to the accountant as well as to the client. A few years spent with small businesses can be a worthy stepping stone for advancement to a larger firm and larger clients. The small practitioner can stress all of these points when interviewing an applicant for a staff position.

Accountants' Tensions

Public accountants have their anxieties and tensions in common with their businessmen clients. Many theories circulate as to the physical effects of excessive pressures, some of which are not proven while others are only generalizations to which an individual may not be subject. There probably is no disagreement that tensions and anxieties can make a man unfit to live or work with.

A pamphlet recently published by the National Association for Mental Health, written by George S. Stevenson, M. D., is a valuable treatise on the subject, ascribing to tensions an aspect of value and essentiality that may be most comforting to sufferers. The author points out that: "Anxiety and tension are essential functions of living just as hunger and thirst are. Without the experience of anxiety we would not be prepared to avoid or overcome situations harmful to ourselves and our families. Without the ability to tense ourselves we would fall short in emergencies, often to the peril of our lives."

Though tensions are considered natural and useful it is nevertheless most desirable, in the interest of good emotional health, that they be eliminated regularly, that one not live constantly in a tense manner. Eleven easy methods for shedding them are prescribed, namely:

1. Talk it out.
2. Escape for a while.
3. Work off your anger.
4. Give in occasionally.
5. Do something for others.
6. Take one thing at a time.
7. Shun the "superman" urge.
8. Go easy with criticism.
9. Give the other fellow a "break."
10. Make yourself "available."
11. Schedule your recreation.

So—start tomorrow by kissing your wife goodbye as you leave for the office, greet your secretary with a cheery "hello" upon arrival there, and make definite your uncertain vacation plans, etc.

Payroll Tax Notes

Conducted by SAMUEL S. RESS

Employer Responsibilities and Costs Affected By Recent N. Y. Labor Law Amendments

Changes in unemployment insurance benefit payment rules which have gone into effect this past month, affect the reporting responsibilities and unemployment insurance costs of New York employers.

Extension of Base Period

Under lowered benefit eligibility rules which went into effect June 23, 1958, an employer should have readily available a claimant's work and wage record for the past 104 weeks as well as the past 52 weeks. The unemployment insurance law amendment to Section 527 thereof provides that in addition to the present requirement that claimant must have worked 20 weeks with earnings averaging $15 a week, a claimant will also be eligible if he has 15 weeks work in the preceding year and 40 weeks work in the two years preceding filing of claim, with average weekly earnings of $15. The effect of this requirement on the wage records that must be kept readily available can be demonstrated by the following situation.

Suppose a former employee files a claim for benefits on August 4, 1958. He was laid off August 1, 1958. Between August 3, 1958 and July 29, 1957, the beginning of the 52 week period immediately preceding the filing date of the claim, claimant had had only 16 weeks of employment with his last employer. It now becomes necessary to ascertain if the claimant had had 40 weeks of employment with his covered employers from July 30, 1956 to August 3, 1958. A search of wage records of three years is now required in such cases.

Avoidance of Delinquency Penalty

Despite the additional time required to search the claimant's wage and employment record, the "LO 12" for such claimants must be returned within the 7 day period required by the statute at the risk of a $10 penalty for delinquency. It would appear that more time should be allotted to employers by the Division of Employment in such cases or that the Industrial Commissioner recognize as good cause for delinquency sufficient to warrant the nonassessment of the $10 penalty, those cases reported

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late because additional time was needed to search the records of a third year. Because of the 2 year statute of limitations for Federal Wage and Hour Law purposes many employers do not keep detailed individual wage and employment records readily available with their current records. It may now be necessary to design forms of individual employees' earnings records to accommodate weekly postings for three years instead of two.

New Benefit Rates

With the weekly earnings limit of partially unemployed claimants increased from $36 to $45 for less than four days work a week, and the creation of nine new benefit rates above the old $36 maximum, ranging at intervals from $37 to $45 for claimants with average weekly wages ranging from $73 to $90 a week or more, the maintenance of a favorable unemployment insurance tax rate will require closer attention than heretofore, if these costs are to be kept under control.

Change in Formula for Charging Employer Accounts

The formula for charging benefit payments to employer accounts has been changed for all new claims filed June 23 and after. Until now, employers were charged in inverse chronological order (last employer first) according to the number of weeks work each employer gave the claimant in the 52 weeks before he filed his claim. This meant that if a claimant qualified for benefits on the basis of 20 weeks of work and received more than 20 benefit payments, the accounts of his base year employers were charged only for the first 20 payments. The additional payments became a charge against the General Account of the Unemployment Trust Fund. Now, instead of debiting the General Account for the excess payments, a second round of charges occurs against employer accounts, starting again with the last employer and working back.

Despite the change to allow benefits in connection with employment for only 15 weeks in the preceding base year provided the claimant could also show 40 weeks of covered employment in the 104 weeks prior to the week in which he filed his benefit claim, the employer or employers who employed the claimant in the preceding 15 weeks would be charged for all the benefit payments. In the example given above, the employer who had given the claimant 16 weeks of work could be charged with 26 benefit payments for the claimant.

Under the Temporary Unemployment Compensation Program pursuant to which claimants may receive an additional 13 weeks of benefits in the benefit year after having exhausted the 26 weeks of benefits, the Industrial Commissioner has announced that benefits paid to claimants for any part of the additional 13 weeks will not be charged to the individual employer's account. It should be noted, however, that provision will have to be made for these additional benefits, and the employer will be faced with additional tax to cover such payments either in the form of higher federal unemployment tax or less favorable merit rating.

With the increased benefit categories and liberalization of the qualifying provisions, more employers may be faced with the possibility not only of losing a present favorable experience rating but also with the danger of having their employer account balances depleted. The top rate for employers with negative accounts (due to the depletion of their account balances by benefit charges exceeding the credits from contributions paid for their accounts) has been raised for the first year to 3.0 per cent, starting January 1, 1959. The top rate for such

employers was formerly 2.7 per cent. If the negative account persists for two successive years, the negative account employer will have to pay contributions at the rate of 3.2 per cent starting in 1960.

Workmen's Compensation

Maximum benefit has been increased from $36 to $45 a week effective July 1, 1958. Minimum benefit rates are increased to $20 a week unless the average weekly wage is less than $20 in which event the benefit rate shall equal the weekly wage. In death cases, the minimum weekly benefit payable to eligible dependents is $20 a week.

A new "loss of hearing" article is now part of the workmen's compensation law for disability found to have occurred on a job associated with harmful noise. Benefits are not to be payable until six months after the worker is separated from the job which caused the loss of hearing.

A claimant who is being rehabilitated under the State Education program to retrain disabled workers, may be permitted to receive $30 a week for maintenance instead of $20 as formerly provided.

Disability Benefits

Disability benefits for off the job disability have been extended from a maximum period of 20 weeks to 26 weeks. Last year the maximum benefit category was raised to $45 a week.

Discrimination in Employment

Employment discrimination because of age of persons 45 to 65 has been prohibited except for persons physically unable to handle the job or pursuant to bona fide retirement systems. The State Commission Against Discrimination has jurisdiction over complaints due to age discriminatory practices.

This is a new area in which laying-off of higher paid older men or women to be replaced by lower paid younger persons, is now prohibited.

Farm Labor Records

Farm labor crew leaders are now required to keep payroll records and to give workers wage statements showing wages earned and deductions made from wages.

Employee Welfare Funds

The Employee Welfare Fund Act has been amended, making it a misdemeanor to file false statements or to make false entries in welfare fund records. It also provides for prohibition of employment of a person involving conflict of interest which adversely affects the interest of the fund. It would appear that this amendment may be of special interest to accountants, lawyers and others who represent the Employee Welfare Fund on the one hand and clients required to make contributions to the same.

Fringe Benefits

Finally, an amendment to the Labor Law regarding wages, makes it a misdemeanor for an employer not to contribute for or provide the wage supplements he has agreed to make or provide, for fringe payroll benefits such as vacation or holiday pay, and sick, death or retirement benefits.

Federal Income Taxation

Decisions and Rulings — RICHARD S. HELSTEIN, C.P.A.

Commentary — Committee on Federal Taxation
Chairman, HERBERT M. MANDELL, C.P.A.

Decisions and Rulings

Renewal of Treasury Cards

The procedure for renewal of Treasury cards, upon their expiration, has been revised with regard to those registrants whose practices are conducted in one of the Brooklyn, Upper Manhattan or Lower Manhattan Districts. Such practitioners must file their renewal applications (form 23A) with the Regional Commissioner of Internal Revenue, 90 Church Street, New York, N. Y., instead of with the Director of the District in which the applicants' practice is located as previously prescribed (Notice, IRB 1958-21, 50).

Transferee Liability for Life Insurance Proceeds

It was previously reported (NYCPA, Vol. XXVIII, No. 1, January 1958, p. 70) that the Supreme Court had granted certiorari in two cases in order to resolve the question of whether beneficiaries of life insurance policies are transferees, and to what extent they are liable, as such, for income taxes unpaid by the decedent at the time of the insured's death. The decisions in these cases have now been published.

In *Com.* v. *Jean F. Stern* (6/9/58, ___ US ___), the Supreme Court upheld the decision of the Sixth Circuit Court of Appeals. It stated that Section 311, IRC 1939 (similar to Section 6901 IRC 1954) is procedural and creates no liability in and of itself. The liability is determined by the law of the state. Since in the instant case, the law of Kentucky, the state involved, provides that, absent fraud, the beneficiary of a life insurance policy is not liable to the insured's creditors, there is no transferee liability to the U. S. Government. Furthermore, since Section 311 does not create a liability, the state law does not defeat a federal lien nor provide an exemption from a federal liability.

In the case of *U. S.* v. *Molly G. Bess* (6/9/58 ___ US ___), the law of the State of New Jersey was similar. However, in this case there did exist a lien in favor of the Government by reason of taxes which were not paid upon notice and demand (see Section 3760 IRC 1939 and Section 6321 IRC 1954) *prior* to the death of the insured. Since a lien did exist, it existed against any property possessed by Mr. Bess in his lifetime. In his lifetime, Mr. Bess had no rights or property in the *proceeds* of the policy, but he did have rights in the *cash surrender value* of the policy. And, the Court reasons, the cash surrender value does not disappear upon death of the insured, but is part of the proceeds paid to the beneficiary, since the proceeds

are, in part, comprised of "a fund" representing "the surplus of the paid premiums accumulated to make up the cash surrender value." Thus, where a lien exists prior to the insured's death, the beneficiary has transferee liability to the extent of the cash surrender value of the policy.

Omission of Gross Income

In a case dealing with Section 275(c) of the 1939 Internal Revenue Code, the Supreme Court has reversed the long-held interpretation of the Tax Court of the meaning of the phrase in that section: "omits from gross income." Section 275(c) extends the statute of limitations for assessment of deficiencies by the Commissioner to 5 years in cases where a "taxpayer omits from gross income an amount . . . in excess of 25 per centum of the gross income stated in the return." The Tax Court has long interpreted this phrase to mean that if cost of goods sold was overstated in sufficient amount so that gross profit from sales was understated by more than 25%; or if, in the case of an individual, excessive deductions resulted in such understatement of gross income from a business; or if overstatement of basis caused a gain upon sale or exchange to be so understated, the Statute would be extended two additional years.

In *The Colony Inc.* v. *Com.* (6/4/58, ___ US ___), the Supreme Court held that the phrase referred to "items" of gross income, or, more simply, gross receipts. Thus, the overstatement of basis, in this case, did not bring Section 275(c) into play.

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The counterpart of Section 275(c) in the 1954 IRC is Section 6501(e)(1)(A), which provides for an extension of the Statute to six years rather than the five years previously allowed. However, Section 6501 (e)(1)(A)(i) specifically answers one of the questions pondered by the Supreme Court by providing that "in the case of a trade or business," gross income means the amounts received or accrued from sales of goods or services. The phrase "in the case of a trade or business" implies that this subsection would not apply to overstatement of basis in the case of a casual sale or exchange of property.

This may be covered by Section 6501(e)(1)(A)(ii) which provides that if sufficient information to apprise the Service of the transaction is shown on the return or on a statement attached to the return, the extended statute shall not apply. Nevertheless, there are conceivable situations where a taxpayer may not attach a statement to the return because of a conviction that under the Code, income from a transaction could not possibly arise in the taxable year.

It will be interesting to see whether these provisions of the 1954 Code are a "cure-all," or if the decision of the Supreme Court will have to be invoked.

Dependent's Support

In determining whether a taxpayer has contributed over one-half of a dependent's support, the Regulations (Section 1.152(a)(2)(i)) have been amended by providing that there will be taken into account the fair market value of "property or lodging." This provision is inserted in lieu of the last two sentences of the above-cited paragraph which had provided for taking into account the fair market value of "goods, services or other benefits."

This change leads to speculation. Obviously it clarifies the Commissioner's

position that the fair market value of lodging shall be taken into account. But if that were the only objective, the phrase "goods, services or other benefits" would not have been eliminated. The way the regulation was written before the revision indicated that the amount of support from all sources including amounts spent for food, shelter, clothing, medical, dental, education and the like *or the fair market value thereof* was to be taken into account. Since the revision, however, the fair market value provision appears to be limited to "property or lodging." Thus, for example, nursing, teaching or other personal services performed by the taxpayer might now be excluded in determining whether a taxpayer is entitled to a dependency credit.

Miscellany

• The "adequate security" deadline for tax exempt organizations has been extended to March 15, 1959 or to the ninetieth day after enactment of legislation amending Section 503, IRC 1954, whichever is earlier. This provision was more fully discussed in NYCPA, Vol. XXVII No. 3, March 1957, pp. 211-212.

• The Commissioner has withdrawn his acquiescence in the *Luther Ely Smith* case (1944, 3 TC 696) and issued a ruling that expenditures to promote or defeat constitutional amendments, as well as any other legislation, are not deductible as ordinary and necessary business expense (Rev. Rul. 58-255, IRB 1958-21, 16).

• Where additional taxes, penalty and interest have been assessed against a cash basis taxpayer, and partial payment is made by such taxpayer without specific instructions as to the application of the partial payment, the payment will be applied to taxes, penalty and interest (in that order) commencing with the earliest year (Rev. Rul. 58-239, IRB 1958-21-7). It is important, therefore, that where the taxpayer wishes to avail himself of an interest deduction in the year of payment, specific instructions accompany the tender of payment.

• The capital gains of an irrevocable, reversionary trust are taxable to the grantor where under state law such gains are to be added to corpus rather than distributed to the income beneficiary (Rev. Rul. 58-242, IRB 1958-21, 23).

• Costs of special education, training and treatment given to a mentally retarded child in an institution are deductible as medical expense. Further, if the availability of medical care at such institution is the principal reason for the child's attendance, the cost of meals, lodging and ordinary education is likewise deductible as medical expense. This ruling does not apply to problem children sent to disciplinary institutions (Rev. Rul. 58-280, IRB 1958-23, 13).

Commentary

Possible Pitfall Following Section 333 Liquidation

The effect of a Section 333 liquidation is to permit the receipt by stockholders of property which has appreciated in value without the recognition of gain on such appreciation. However, there are problems that may arise in the application of this section which may offset the advantages intended by Congress.

Following a liquidation under Section 333, the basis of assets received is deter-

mined under Section 334(c) and Regulation Section 1.334-2. The latter requires the allocation of basis to specific noncash assets in the ratio of relative fair market values. The effect of this rule may be to require a stepdown in basis for certain assets which will produce subsequent ordinary income to the stockholder. This result must be considered in evaluating the desirability of a Section 333 liquidation.

The regulation requires that the basis of the assets *other than cash* in the hands of the stockholder be allocated to the individual assets in proportion to the fair market value of the individual assets at the date of liquidation. Under this allocation procedure, receivables and inventory would receive a new basis which may be less than the basis in the hands of the liquidating company. The result of this would be to cause the stockholders to realize a part of fixed assets appreciation as ordinary income upon collection of the receivables and sale of the inventory. This may be illustrated by the following example.

1. Balance Sheet—X Co. (As of date of liquidation under Section 333).

	Adjusted Basis	Fair Market Value
Cash	$ 1,000	$ 1,000
Accounts Receivable	2,000	2,000
Inventory	3,000	3,000
Land and Buildings..	100,000	200,000
	$106,000	$206,000
Capital Stock	$100,000	
Earned Surplus	6,000	
	$106,000	

2. Calculation of aggregate basis to sole stockholder of assets received in liquidation, other than cash.

Assumed basis of X Co. stock..	$100,000
Less—Cash received	1,000
	$ 99,000
Add—Gain recognized under Section 333	6,000
Basis of noncash assets received	$105,000

3. Allocation of basis to specific assets per Regulation Section 1.334-2.

Accounts receivable	$\frac{2,000}{205,000} \times \$105,000 =$	$ 1,024
Inventory	$\frac{3,000}{205,000} \times \$105,000 =$	1,537
Land and Buildings	$\frac{200,000}{205,000} \times \$105,000 =$	102,439
Total basis of noncash assets		$105,000

Since the purpose of Section 333 is generally to eliminate the realization of gain in a qualified liquidation, it would appear that the computation under Regulation Section 1.334-2 is in conflict with this purpose. In view of the inequitable results which might follow, careful consideration should be given to the basis allocation to the stockholders whenever the desirability of a Section 333 liquidation is being evaluated.

Forgiven Indebtedness and the Net Operating Loss

One of the members of our Society submitted a problem which is of general interest. The specific question was

whether or not a net operating loss deduction must be reduced by the amount of a forgiven debt, where such forgiveness did not result in taxable income to the debtor taxpayer for the reason that both before and after the forgiveness such taxpayer was insolvent.

It is well known that, in general, a taxpayer realizes income from the cancellation of its debts (*U.S.* v. *Kirby Lumber Co.*, 284 U.S. 1). However, if a taxpayer was insolvent prior to the forgiveness, taxable income is realized only to the extent of the solvency resulting from the forgiveness of indebtedness. (*Lakeland Grocery Co.*, 36 B.T.A. 289, and later decisions following this case.) The problem here involved is whether that portion of forgiveness which can be omitted from gross income does not reduce the net operating loss carryover.

There seems to be no doubt that the net operating loss will not be affected by the forgiveness. Section 172(c) of the 1954 Code states in quite unambiguous language that the net operating loss means the excess of the deductions allowed under Chapter 1 over gross income, both computed with the modifications specified in Section 172(d). Since, under the Court decisions, gross income does not arise to the extent that the taxpayer is insolvent, the gross income to be used in the computation will not include that portion of the forgiveness which does not create such solvency. Furthermore, the modifications enumerated in Section 172 (d) seem to contain a complete and all-inclusive list of the adjustments required by law. No mention is made of any adjustment by reason of debt forgiveness. Apparently, therefore, no amount of forgiven indebtedness has to be taken into account which does not result in the creation of gross income. This applies to the computation of the net operating loss as well as to the computation of the income of the years to which the net operating loss is carried over.

The Benefits of Section 337 and Collapsible Corporations

Under Section 337, if a corporation adopts a plan of complete liquidation and completes such liquidation within twelve months thereafter, the corporation need pay no tax on the gains from the sales or exchanges of certain of its property during that twelve-month period. However, under Subsection 337(c)(1), this special exemption does not apply to sales or exchanges made by a collapsible corporation as defined in Section 341(b).

Suppose Corporation X holds a single piece of property, an office building, the construction of which was completed by the corporation on December 31, 1954. During 1958, more than three years after completion, a buyer is found for the property at a price involving a substantial profit. The buyer insists on purchasing the real estate rather than the stock of the corporation. May the corporation effect the sale and avail itself of the benefits of Section 337? If it may not, how should the sale be consummated at the cost of a single tax?

It will be assumed that upon completion of the building the corporation fell within the definition of a collapsible corporation under Section 341(b). Under Section 341(d) a stockholder of a collapsible corporation, such as Corporation X, could realize a gain on his stock through sale, exchange, or liquidating distribution without such gain being subject to the collapsible corporation provisions, provided the gain was realized more than three years after completion of the building. It will be noted that Section 341(d) speaks of a stockholder in a collapsible corporation being exempt from its provisions under the circumstances described. This raises

the question whether a corporation can retain its character as a collapsible corporation as defined in Section 341(b) despite the fact that its stockholders are not subject to the provisions of that section. If it does so retain its character under the cited subsection, the corporation is not eligible to the benefits of Section 337.

The Regulations under Section 337 reflect the position that a corporation may be "collapsible" and ineligible for the use of Section 337 even though its stockholders are "in the clear" under Section 341(d). It follows, therefore, that even after the expiration of three years following the completion of construction of the building by Corporation X, the corporation may still be treated as "collapsible" and be denied the benefits of Section 337. While there does not seem to be much point in retaining collapsible status for the purpose of defeating the use of Section 337, particularly after the stockholders are no longer bound by its provisions, the statute, as written, does lend support to such a result.

Would the foregoing conclusion be different if Corporation X had purchased the office building on December 31, 1954, instead of constructing it? It has been stated that if the property had been acquired by purchase instead of having been constructed, the corporation would cease to be "collapsible" for the purpose of Section 337 at the expiration of three years from the date of purchase. The reason for this is that Subsection 341(b) defines the term collapsible corporation to mean "a corporation formed or availed of principally for the manufacture, construction, or production of property, for the purchase of property which (in the hands of the corporation) is property described in paragraph (3)." Paragraph 3 defines "section 341 assets" to mean property held for a period of less than three years. Therefore, by the insertion of the comma after "production of property" and before "for the purchase" it would appear that section 337 could be used for *purchased* property held for more than three years.

However, some tax authorities have held that the result may be the same whether the property were purchased or constructed. Subsection 341(d) states the circumstances which relieve a stockholder in a corporation which is otherwise collapsible, from the application of that section. Thus, the provisions of Section 341 do not apply to the gain realized by a stockholder of a collapsible corporation after the expiration of three years following the completion of such manufacture, construction, production or *purchase*. (Subsection 341(d)(3).) There would have been no need to include "purchase" in the foregoing exception to the application of the rules governing collapsible corporations, if, three years after the purchase, the corporation itself ceased to be a "collapsible corporation."

In view of the foregoing, the stockholders should consider a complete liquidation of the corporation first, and then a sale of the property with due regard, of course, to the pit-falls of the *Court Holding Co.* doctrine.

Disposition of "Jointly Held Restricted Stock"

If an employee disposes of stock acquired under a restricted stock option plan within two years from the date of granting the option, or within six months after acquiring the stock by exercising the option, he will be considered as having received ordinary income at that time to the extent that the value of such stock exceeds the purchase price under the option. Subsection 421(d)(4) defines a disposition to include a transfer of legal title. However, such section excludes the transfer of a share of stock

from the employee, as sole owner, into his name and another jointly, with the right of survivorship. A question arises as to whether or not a "disposition" occurs if the stock is registered in the name of the employee and his wife as joint tenants, with the right of survivorship, if the employee dies within the two-year or six-month periods.

The Commissioner, in an informal ruling, has taken the position that under such circumstances there would be a "disposition." Consequently, it is suggested that a taxpayer avoid the possibility of this burdensome "disposition" by waiting until the two-year period and the six-month period have expired before creating the joint tenancy. Thus, once both these periods have elapsed, the taxpayer could transfer the stock from his own name to his name and his wife jointly, with the right of survivorship, and such transfer would not be a "disposition" under Subsection 421(d)(4)(B). The only detrimental aspect to this delayed creation of the joint ownership would be the possibility that the stock may have increased in value and consequently increase the gift tax payable, if any, on the creation of the joint tenancy.

Criminal Penalties Possible for Failure to Pay Tax

Taxpayers short of cash occasionally may find it necessary to file a return without paying the tax. In time, the Internal Revenue Service bills such taxpayers for their unpaid liability and adds interest at the rate of 6 per cent per annum. In general, this has always been the procedure and, as long as the tax was paid, there was never any threat of penalties or sanctions by the Treasury Department.

In a recent case, *U.S.* v. *Frank Palermo* (152 F. Supp. 825, D.C., Pa., May 31, 1957), the taxpayer was charged with criminal penalties, under Section 7203, for filing his return but not paying the tax due. He sought to have the charge dismissed on various grounds, the primary one seeming to be that he was being discriminated against because many taxpayers did the same thing but were not prosecuted. The Court refused to dismiss the charge against Palermo. It dealt with his discrimination argument by saying, first, that there is a clearly recognized principle that failure to prosecute all criminals is no defense to the one prosecuted and by going on to say:

> It seems too clear for argument that a taxpayer who wilfully fails to pay his tax when due, having ample assets to use for the purpose, may most properly be treated differently under these criminal provisions, from the many taxpayers whose economic conditions make it far more difficult for them to pay their taxes when due.

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